REPORT OF THE STUDY GROUP
ON
NON-BANKING COMPANIES

RESERVE BANK OF INDIA
BOMBAY
1975

Copies can be had from :

The Administrative Officer,
Economic Department,
Reserve Bank of India,
Post Box No. 1036,
Bombay-1.

Price: Rs. 10 (postage extra)

Published by B. Rangaswamy for the Reserve Bank of India, Bombay, and Printed by G. G. Pathare at the Popular Press (Bom.) Private Ltd., 35C, Tardeo Road, Bombay 400 034.

J. S. RAJ
Chairman

UNIT TRUST OF INDIA
Post Box No. 2000
BOMBAY-1.

July 14, 1975
Asadha 23, 1897

Shri S. S. Shiralkar,
Deputy Governor,
Reserve Bank of India,
Bombay.

Dear Sir,

Study Group on Non-Banking Companies

I have pleasure in presenting herewith the Report of the Study Group constituted by the Reserve Bank of India in June 1974 for examining in depth the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 and the directions issued thereunder, in order to assess their adequacy in the context of ensuring the efficacy of the monetary and credit policy of the country and affording a degree of protection to the interests of the depositors who place their savings with non-banking companies.

With a view to eliciting public opinion on the various aspects of its forms of reference, the Group addressed suitable letters to certain individuals, bankers and representative organisations of trade, industry and commerce. It also visited a few important centres like New Delhi, Calcutta and Madras for the purpose of holding discussions with certain individuals/representatives of organisations. Having taken into account the views expressed in the written memoranda submitted to it and the discussions, the Group has made its recommendations on the various issues which arose for its consideration. A summary of major conclusions and recommendations is given in Chapter 8 of the Report.

3. It will be seen from the Report that the Group has made various suggestions—legislative, organisational and procedural—to remedy the deficiencies observed by it in the present regulations governing deposit-acceptance activities of non-banking companies. It has also taken note of the developments subsequent to the constitution of the Group, viz., the insertion of two new sections 58A and 58B in the Companies Act, 1956 by the Companies (Amendment) Act, 1974 which empower Government to regulate deposit-

acceptance activities of non-financial companies and the making of the Companies (Acceptance of Deposits) Rules, 1975 thereunder which came into force with effect from February 3, 1975.

4. The consensus of opinion as put forward before the Group was that the present situation in which there has been a spurt in deposits with non-banking companies is an abnormal one brought about by a combination of temporary factors like credit control measures and restrictions on declaration of dividends paid by companies. In making its recommendations, the Group has, therefore, been guided by two main considerations. First, while the aim should certainly be to ensure that the measures proposed to regulate deposits and the activities of non-banking companies should be more effective than hitherto, they should not be so stringent or rigid as adversely to affect production or investment. Secondly, the Group has given due weightage to the administrative feasibility of the proposals; wherever the choice was between a solution which was theoretically perfect but not quite practicable and another which was theoretically less perfect but administratively more feasible, it has chosen the latter. The Group has recommended strengthening of the administrative organisation within the Reserve Bank for effective enforcement of the regulatory measures proposed by it.

5. The major recommendation of the Group is that while the acceptance of deposits by non-banking non-financial companies may not be prohibited altogether, it should be discouraged and reduced in due course. An important element in the scheme of regulation suggested by the Group is, therefore, to limit and reduce over a period of time the quantum of deposits so that they cease to be a significant source of finance for industry and trade; this would indirectly reduce to some extent the risk to depositors. The Group has also recommended that non-banking non-financial companies should keep a portion of the deposits maturing during the course of the year in liquid assets and should, in their advertisements, present their financial position in a more informative manner.

6. So far as non-banking financial companies are concerned, the Group has taken the view that considering the nature of their operations they should be regulated broadly on the same lines as banks and should be under the close surveillance of the Reserve Bank. Also, their activities have to be justified by reference to the geographical or functional gaps that exist in the financial system. Thus, a selective approach has been adopted to different types of non-banking financial companies. The Group has not recommended any ceilings on deposits with nidhis which deal only with their members as also on deposits with housing finance companies which, in the present circumstances, deserve to be encouraged. As for hire-purchase finance companies, there is no ceiling at present on the deposits accepted by them. A ceiling has now been suggested mainly with the object of introducing a

measure of discipline among the companies and affording a degree of protection to the depositors' interests. In the case of loan companies, the Group has suggested ceilings on deposits higher than those which are currently operative, taking into account the need for making them viable units. Further, it is possible that as a result of debarring sole proprietorships and partnership firms from accepting deposits, some of these financial institutions (e.g., "Finance Corporations" of the type operating in Bangalore and some other places in South India) may convert themselves into hire-purchase finance or loan companies. So far as investment companies are concerned, the Group has recommended the continuance of the ceilings on their deposits as at present (with a progressive reduction as in the case of non-banking non-financial companies) taking into account the sources of their funds and the nature of their operations. It may be added that the Group's recommendations in regard to ceilings on deposits with financial companies have to be viewed in conjunction with its suggestions on the prescription of minimum level of paid-up capital and reserves, maintenance of liquid assets and other regulatory measures.

7. As regards miscellaneous non-banking companies, the Group has recommended that the activities of companies conducting prize chit/benefit schemes should be banned. As for conventional chit funds, it has already furnished its comments to the Reserve Bank on the draft model Bill for regulating their working.

8. On behalf of the Group and of myself, I would like to express our gratitude to the Reserve Bank for the confidence reposed by the Bank in entrusting the work to us. I trust that the Bank would find the recommendations made by the Group of some use in formulating its policies in regard to deposit-acceptance and other related activities of non-banking companies.

Yours faithfully,

Sd/-
(J. S. Raj)
Chairman
Study Group on Non-Banking Companies

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CHAPTER 1

INTRODUCTORY

GENESIS OF THE STUDY GROUP

1.1 The Banking Commission constituted by the Government of India to review, *inter alia,* "the role of various classes of non-banking financial intermediaries, to enquire into their structure and methods of operation and to recommend measures for their orderly growth" made certain recommendations in this regard in its report submitted to the Government in January 1972. These recommendations were examined by the Reserve Bank of India. In the light of the views expressed by the Reserve Bank thereon, the Government of India decided that the relative provisions of the Reserve Bank of India Act, 1934 and the directions issued thereunder to non-banking companies may be reviewed to plug loopholes, if any, which were being taken advantage of, particularly by private limited companies.

1.2 With a view to examining this matter in all its aspects, the Reserve Bank of India, by an order issued on June 12, 1974* (as modified by its orders dated June 17, 1974 and January 30, 1975), constituted the present Study Group. Its composition was as follows:

1.	Shri James S. Raj, Chairman, Unit Trust of India, Bombay.	Chairman
2.	Shri K. B. Chore, Joint Chief Officer, Department of Banking Operations & Development, Reserve Bank of India, Bombay.	Member
3.	Shri V. G. Hegde, Joint Legal Adviser, Reserve Bank of India, Bombay.	Member
4.	Shri A. Hasib, Director, Division of Fiscal Analysis, Economic Department, Reserve Bank of India, Bombay.	Member

*See Appendix I

5.	Shri D. M. Sukthankar, Director, Department of Banking, Ministry of Finance, Government of India, New Delhi.	Member
6.	Shri R. N. Bansal,* Additional Director of Inspection & Investigation, Department of Company Affairs, Government of India, New Delhi.	Member
7.	Shri V. Subramanian, Chief Officer, Department of Non-Banking Companies, Reserve Bank of India, Calcutta.	Member
8.	Shri B. N. Chikarmane,@ Assistant Chief Officer, Department of Non-Banking Companies, Reserve Bank of India, Calcutta.	Member-Secretary

1.3 Shri D. D. Bhargava, the then Chief Officer, Department of Non-Banking Companies, Reserve Bank of India, Calcutta, served on the Study Group from June 17, 1974 till January 30, 1975 when Shri V. Subramanian was appointed as a Member of the Group after he took over as the Chief Officer of the Department.

TERMS OF REFERENCE

1.4 The terms of reference of the Group were as follows:

I. To examine the relative provisions of the Reserve Bank of India Act, 1934, the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, and the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973, with a view to assessing their adequacy in regulating the conduct of business by the non-banking companies covered by the said directions in the context of the monetary and credit policies laid down by the Reserve Bank from time to time; to suggest measures for further tightening up the provisions so as to ensure that the activities of such companies, in so far as they pertain to the acceptance of deposits, investments, lending

*At present Regional Director, Company Law Board, Southern Region, Madras.
@At present posted in Bombay.

operations, etc., subserve the national interest and serve more effectively as an adjunct to the regulation of the monetary and credit policies of the country besides affording a degree of protection to the depositors' monies.

To examine and make recommendations for regulating the conduct of the business of non-banking companies governed by the above sets of directions generally, and in particular, in regard to—

(a) the norms which may be adopted in respect of the capital structure and debt-equity ratio that may be maintained by the various classes of non-banking companies covered by the said directions;

(b) the extent to which and the periods for which such companies may borrow by way of deposits/unsecured loans and the distinctions, if any, to be made between public and private limited companies for this purpose;

(c) the maintenance of cash reserves and/or a percentage of their deposit liabilities in the form of liquid assets by such companies;

(d) the norms which may be adopted in respect of the rates of interest payable by such companies on their borrowings by way of deposits/ unsecured loans and also those which may be charged on loans and advances made by them;

(e) the extent to which any of the activities carried on by these companies through their subsidiaries can or should be controlled;

(f) the need for the imposition of a ceiling on risk assets to be acquired or loans to be granted by the companies;

(g) the restrictions, if any, on the grant of loans to directors and their friends and relations and companies in which they are interested;

(h) the manner in which the loopholes, if any, in the existing directions taken advantage of by private limited companies in the context of certain concessions enjoyed by such companies under the provisions of the Companies Act, 1956, could be plugged; and

(i) the need to empower the Bank to apply for compulsory winding up of non-banking financial companies under certain circumstances.

II. To make recommendations on any other related topic which the Study Group may consider germane to the subject matter of the enquiry.

1.5 As per the order of the Reserve Bank of India dated June 12, 1974 referred to above, an examination of the relative provisions of the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966, did not fall within the purview of the terms of reference of the Study Group. Subsequently, however, in partial modification of the order, the Reserve Bank

issued another order on September 4, 1974* extending the scope of the enquiry to include companies covered by the above directions.

METHODOLOGY ADOPTED BY THE GROUP AND THE MEETINGS HELD BY IT

1.6 The Study Group issued a circular letter dated September 11, 1974 to certain bankers, economists and individuals having intimate knowledge of the deposit-acceptance activities of non-banking companies as well as to representative organisations of trade, industry and commerce and requested them to furnish it with detailed memoranda on the matters referred to in the terms of reference and more particularly on the points specified in Annexure F thereto†. On the basis of the memoranda submitted by the respondents, the Group had discussions with some of them as also others who had not submitted any memoranda. For this purpose, the Group visited important centres, viz., Ahmedabad, Bangalore, Calcutta, Cochin, Madras and New Delhi. At its meetings in Bombay and elsewhere, the Group also held discussions with some officials of the Central and State Governments. The Member-Secretary of the Group visited Hyderabad and Trivandrum for the purpose of eliciting the views of the Governments of Andhra Pradesh and Kerala on certain aspects relating to regulation of chit funds. A list each of the individuals and representatives of organisations who submitted the memoranda and with whom the members of the Group had discussions on the various aspects relating to the terms of reference is appended@.

1.7 The Study Group met at different centres as under:

	Place	Dates of the meetings
1.	Bombay	July 5 and 6, 1974
2.	Bombay	August 30 and 31, 1974
3.	Ahmedabad	November 1 and 2, 1974
4.	New Delhi	November 16, 18 and 19, 1974
5.	Calcutta	November 30 and December 2, 1974
6.	Bangalore	December 19, 1974
7.	Cochin	December 20 and 21, 1974
8.	Madras	January 20 and 21, 1975
9.	Bombay	February 13, 14 and 15, 1975
10.	Bombay	March 6 and 7, 1975
11.	Bombay	March 24 and 25, 1975
12.	Bombay	May 14 and 15, 1975
13.	Bombay	May 23 and 24, 1975
14.	Bombay	June 17 and 18, 1975
15.	Bombay	July 14, 1975

*See Appendix I.
†See Appendix II.
@See Appendices III and IV.

SCHEME OF THE REPORT

1.8 The subject matter of the terms of reference has been dealt with broadly under five heads, viz., (i) Evolution of the regulations; (ii) Non-Banking Non-Financial Companies; (iii) Non-Banking Financial Companies; (iv) Miscellaneous Non-Banking Companies and (v) Administrative arrangements. After dealing with the general approach to the problem and analysing it from the quantitative as also qualitative points of view in Chapter 2, the evolution of the present regulations governing acceptance of deposits by non-banking companies is traced in Chapter 3. This chapter further sets out the important aspects of the statutory provisions in Chapter IIIB of the Reserve Bank of India Act, 1934, as amended up to date, which deals with the regulation of activities of non-banking institutions receiving deposits and of financial institutions. Also included in this chapter is a discussion of the salient features of the three sets of directions issued by the Reserve Bank to non-banking financial and non-financial, and miscellaneous non-banking companies, and of the statutory returns prescribed under the said directions. Chapter 4 examines the deposit-acceptance activities of non-banking non-financial companies in the context of certain issues such as protection of the depositors' interests, period of deposits and rates of interest payable on deposits. In view of the coming into force of the Companies (Acceptance of Deposits) Rules, 1975 with effect from February 3, 1975 regulating the acceptance of deposits by non-financial companies, the broad features of these rules are also analysed in this chapter and certain suggestions are made for amending them. Chapter 5 deals with the various facets of regulation of deposit-acceptance activities and other related aspects of business of non-banking financial companies. Chapter 6 covers miscellaneous non-banking companies, i.e., companies conducting what are commonly known as prize chits/benefit schemes/lucky draws as also companies conducting conventional type of chits. In the context of the recommendations made by the Banking Commission in regard to regulating the activities of non-banking financial intermediaries, the Central Government had, *inter alia,* decided that a model law to regulate chit fund business may be formulated by the Reserve Bank for adoption by all the States which have no such legislation. Pursuant to the said decision, the Reserve Bank drafted a model Bill and sought the views of the Study Group on certain policy aspects arising from the provisions proposed to be incorporated therein. The views of the Group in this regard, which have since been conveyed to the Reserve Bank, are also included in Chapter 6. The Group envisages that a reorientation and strengthening of the administrative set-up of the Department of Non-Banking Companies in the Reserve Bank will have to be considered so as to ensure that such of its recommendations as are found acceptable are promptly implemented and effectively enforced. All these aspects are discussed in Chapter 7. Finally, a summary of the major conclusions and recommendations of the Group is given in the last chapter of the Report.

ACKNOWLEDGEMENT

1.9 The work of the Study Group could not have been completed without the co-operation of institutions and individuals who submitted memoranda to the Group and gave it the benefit of their views in the course of the discussions. The Group is grateful to all of them.

1.10 The Study Group owes a special debt of gratitude to its Member-Secretary, Shri B. N. Chikarmane. Apart from organising the work of the Group, he collected useful information from Indian and foreign institutions, undertook thoughtful studies and prepared the preliminary draft report of the Group. His intimate knowledge of the regulations of non-banking companies in India was of considerable help in facilitating the work of the Group. Sarvashri M. V. Vengsarkar, V. Srinivasan, B. B. Das and other members of the staff of the Department of Non-Banking Companies assisted the Member-Secretary in the discharge of his arduous duties. Shri C. R. Shah of the Department of Statistics, Reserve Bank of India, rendered useful service to the Group by compiling statistical data.

1.11 The Economic Department of the Reserve Bank carried out some useful field studies for the Group; Shri P. D. N. Rao prepared a study relating to the operations of "Finance Corporations" in Bangalore, and Sarvashri P. V. Narasimham and M. Y. Khan undertook a survey of the activities of Finance Companies in Delhi. Dr. M. Saravane was good enough to edit the Report. The Group wishes to express its thanks to all of them.

CHAPTER 2

APPROACH TO THE PROBLEM—QUANTITATIVE AND QUALITATIVE ASPECTS

INTRODUCTION

2.1 In examining the question of regulating the acceptance of deposits by Non-Banking Companies (NBCs), the major issues which arise are the nature and magnitude of such deposits and the role that they play in the economy, particularly by influencing the quantum and pattern of savings and investment. Two important aspects of these questions are the effect of the acceptance of deposits by NBCs on the efficacy of monetary and credit policy and the degree of risk to the depositors in placing their savings with such companies. The specific aspects of these issues in relation to different kinds of NBCs will be considered in the relevant chapters of the Report. In this chapter we shall discuss the broad aspects of these issues and enunciate the general approach adopted by the Study Group in making its recommendations.

TYPES OF NBCs

2.2 As pointed out by the Banking Commission in its Report*, undertakings accepting deposits may be divided into three categories, viz.,

(i) those accepting chequeable deposits;
(ii) those accepting non-chequeable deposits for the purpose of lending or investment; and
(iii) those accepting non-chequeable deposits for financing their own business such as manufacture or trade.

Undertakings falling in category (i) above are termed as banks, those in (ii) as non-banking financing institutions and those in (iii) as deposit receiving institutions. In accordance with its terms of reference, the Study Group is concerned with the institutions of the types mentioned in (ii) and (iii) above and that too only with companies incorporated under the Companies Act, 1956. It may be pointed out at the outset that there is a difference between the classification of NBCs adopted by the Company Law authorities and the Department of Non-Banking Companies of the Reserve Bank of India. While the Company Law authorities classify companies at the time of their registration on the basis of the main objects as projected in their Memorandum of Association, the Reserve Bank categorises companies only after they have functioned for some time and on the basis of the pattern of assets and principal sources of income as disclosed in their balance sheets and profit and loss accounts. Moreover, under the directions issued by the

*Government of India, Report of the Banking Commission (1972); paragraph 19.26

Reserve Bank, companies in liquidation are excluded. The Study Group has used the definitions adopted by the Reserve Bank for the purpose of classification of NBCs mainly because more detailed statistics have been compiled by the Bank from the returns submitted by NBCs.

NATURE AND MAGNITUDE OF DEPOSITS*

2.3 The Table below shows the growth of deposits with NBCs in relation to growth of deposits with scheduled commercial banks since 1963 (Table 2.1).

2.4 Owing to the failure of some companies to submit the prescribed returns, there would always be an element of underestimation in the figures of total deposits with NBCs compiled from such returns received by the Reserve Bank. Also, due to the amendments effected from time to time in the directions issued by the Reserve Bank and variations in the number of companies submitting returns, the figures of deposits cannot be taken as strictly comparable over the years.

TABLE 2.1 — GROWTH IN DEPOSITS WITH SCHEDULED COMMERCIAL BANKS AND NON-BANKING CORPORATE SECTOR—1963-1972

(Amounts in crores of rupees)

	All scheduled commercial banks		Non-banking companies		
As at the end of March	Amount	Percentage rate of growth over the previous year	Amount	Percentage rate of growth over the previous year	Col. 4 as percentage of col. 2
(1)	(2)	(3)	(4)	(5)	(6)
1963	2042.3	6.3	153.9	13.6	7.5
1964	2285.1	11.9	185.9	20.8	8.1
1965	2583.3	13.0	209.1	12.5	8.1
1966	2949.8	14.2	283.4	35.5	9.6
1967	3425.5	16.1	338.5 (430.5)	19.4	9.9
1968	3856.0	12.6	398.3 (477.9)	17.7	10.3
1969	4338.2	12.5	472.1 (593.7)	18.5	10.9
1970	5028.2	15.9	505.2 (633.3)	7.0	10.0
1971	5906.2	17.5	568.7 (644.9)	12.5	9.6
1972	7105.9	20.3	691.8	21.7	9.7

Note: Figures for the period 1963 to 1966 and those in brackets from 1967 to 1971 represent deposits including foreign loans.

Source: Article on "Growth of Deposits with Non-Banking Companies, 1971-72"; Reserve Bank of India Bulletin, April 1975, pp. 235-246.

*Throughout this report, the figures of deposits include exempted loans unless otherwise stated.

2.5 The latest survey of deposits with NBCs relating to end March 1972 reveals that the total deposits (excluding foreign loans) held in the non-banking corporate sector by 3155 reporting companies (921 financial and 2234 non-financial companies) aggregated Rs 691.8 crores showing an increase of Rs 123.1 crores over the quantum of such deposits on the corresponding date of the previous year*. Of the aggregate deposits of Rs 691.8 crores, Rs 480.8 crores were accounted for by non-financial companies and the remaining Rs 211.0 crores by financial companies. In other words, the deposits with non-banking non-financial companies constituted 69.5 per cent of the total deposits in the non-banking corporate sector. A major portion of deposits accepted and held in the non-banking corporate sector was accounted for by companies having deposits of more than Rs 25 lakhs each as on March 31, 1972. Thus, out of 3155 reporting companies, 490 companies (15.5 per cent) accounted for 78.2 per cent of the outstanding deposits. There is evidence to show that the dependence of non-financial companies on deposits has tended to increase, and at the same time, the liquidity of these companies in relation to the amount of deposits accepted by them has tended to decline. A sample study of selected 163 non-financial companies showed that deposits as a percentage of equity increased from 15.7 as at the end of March 1972 to 16.4 as at the end of March 1973. Likewise, the proportion of deposits to total capital employed (i.e., total liabilities net of depreciation) increased from 5.9 per cent to 6.1 per cent and the proportion of deposits to inventories went up from 19.3 per cent to 19.9 per cent. While the deposits tended to increase, the liquid assets of these companies as a proportion of deposits declined from 59.1 per cent to 48.9 per cent.

TABLE 2.2—VARIOUS RATIOS OF SELECTED 163 NON-FINANCIAL COMPANIES ACCEPTING DEPOSITS FROM THE PUBLIC

Year	Deposits as percentage of equity	Deposits as percentage of total capital employed	Liquid assets as percentage of deposits	Deposits as percentage of inventories
(1)	(2)	(3)	(4)	(5)
1971-72	15.7	5.9	59.1	19.3
1972-73	16.4	6.1	48.9	19.9

2.6 As the data relating to the deposits of NBCs for the post 1972-73 period based on the returns have not yet become available, an estimate of such deposits has been made in the following manner. Based on the rate of growth of these deposits in the recent past and a quick survey of deposits covering companies holding deposits of more than Rs 25 lakhs, the quantum of these deposits is estimated at Rs 1080 crores at the end of June 1974.

*See Reserve Bank of India Bulletin April, 1975 pp. 235-246.

It is also estimated that NBCs might have accepted further deposits to the extent of Rs 200 crores during the period July 1974 to March 1975. Thus, on a rough basis, the aggregate deposits held by the non-banking corporate sector at the end of March 1975 may be assessed at around Rs 1300 crores. At this level, the percentage of these deposits to the deposits of scheduled commercial banks may be estimated around 11 as against 9.7 at the end of March 1972.

2.7 A comparison of the growth rate of deposits of commercial banks with that of NBCs leads us to the question of the basic differences between these two types of deposits. The major advantages which commercial bank deposits have over NBC deposits are the following. First, cheque facilities are offered on demand deposits and certain types of savings deposits of commercial banks whereas no such facilities are available in the case of deposits with NBCs because NBCs are not allowed to accept chequeable deposits. Secondly, deposits with commercial banks are insured to the extent of Rs 10,000 per account, whereas deposits with NBCs are not covered by insurance. Thirdly, the interest on commercial bank deposits along with the return on other eligible savings is exempt from income-tax to the extent of Rs 3,000; the corpus of such deposits along with other eligible investments in financial assets is also exempt from wealth tax to the extent of Rs 1.5 lakhs. There are no such tax concessions or exemptions in the case of deposits with NBCs.

2.8 Deposits with NBCs have, however, grown in spite of the fact that there are certain advantages attached to commercial bank deposits which are not available in the other case. The growth of deposits with NBCs cannot be attributed to the absence of banking facilities. The available data on the State-wise distribution of deposits of NBCs show that a preponderant proportion of the total deposits is held by companies in those States which, on the whole, are well served by commercial bank offices. Also, commercial banks have devised various savings schemes to suit the preferences of various categories of depositors. The basic reason, therefore, for the growth of deposits of NBCs is that these companies pay interest rates higher than those paid by commercial banks. The differential in interest rates paid on deposits by commercial banks and NBCs of good reputation has definitely increased since July 1974. Also, the new companies which solicit deposits from the public have found it necessary to offer even higher interest rates than those offered by the existing companies. While the interest rates on deposits of commercial banks are regulated by the Reserve Bank, there is no direct regulation of the rates of interest paid by NBCs on deposits raised by them.

2.9 The acceptance of deposits by NBCs is not an entirely new phenomenon in the country. Historically, textile mills, particularly in Ahmedabad and Coimbatore, financed even a part of their fixed capital assets by recourse to

acceptance of deposits from the public. Since banking facilities and habits were rather undeveloped at the time, the public found in these deposits a convenient means of putting their savings and earning interest. Later, with the spread of commercial banking system, the growth of deposits with banks was quite rapid. However, an active monetary policy adopted by the Reserve Bank from the late fifties and recourse in particular to selective credit controls resulted in more companies soliciting deposits directly from the public. As will be discussed in the next chapter, the growth of deposits with NBCs during that period was the immediate cause for the regulation of deposits by the Reserve Bank.

2.10 The more recent spurt in these deposits is, however, due to a combination of factors. First, the very rapid rise in prices and the consequent decline in the purchasing power of money made the relatively higher interest yielding deposits of NBCs more attractive to the savers. In other words, the differential in interest rates paid by NBCs and by banks to the depositors was wide enough to offset the element of greater risk involved in putting savings with the former. Aggressive advertising campaign, both by companies and brokers, has also played a part in attracting savings of the household sector to NBCs. Some members of the public seem to have been misled about the degree of risk involved in keeping deposits with NBCs under the mistaken belief that regulation of these deposits by the Reserve Bank was tantamount to an assurance that they are safe. Secondly, the anti-inflationary measures undertaken by the Government and the Reserve Bank, particularly since the middle of 1974, had the double effect of making deposits with NBCs more attractive to certain savers and making it more profitable for deposit-accepting companies to supplement their resources by having recourse to such deposits. The restrictions placed on the declaration of dividends combined with rapidly falling purchasing power of money has resulted in an observed shift from the savings media like shares and debentures of companies and units of the Unit Trust of India to deposits with NBCs. It was also suggested to the Study Group that the chances of being able to evade the payment of income-tax on interest on deposits with NBCs were greater than in the case of income from other savings media. The companies also faced a situation under which not only the cost of borrowing from commercial banks went up from about 12-13 per cent to as much as 16-18 per cent, but they were subjected to greater financial discipline in the management of their inventories, etc., because of the credit restraint measures introduced by the Reserve Bank over the commercial banks. As a result, whereas the depositors of NBCs currently get an interest rate which is higher by 3-4 per cent than that offered by banks, the companies too pay interest on these deposits at a rate which is 3-4 per cent lower than what they have to pay to the commercial banks on their borrowings.

2.11 The above discussion shows that, although the magnitude of deposits

with NBCs in relation to the total bank deposits and other savings media is still limited, there is enough evidence of the acceleration in the growth of these deposits. The question, therefore, arises as to the effect of this phenomenon on the economy.

ROLE OF NBC DEPOSITS IN THE PROCESS OF SAVINGS AND INVESTMENT

2.12 The impact of the accelerated growth of deposits with NBCs on the economy can be analysed in terms of its effect on the quantum and pattern of savings and investment. This is because the development of the economy depends to a large extent on the increase in the rate of savings in relation to national income and the use of these savings for productive purposes in accordance with social objectives. According to the latest figures available, the proportion of net domestic capital formation financed by net domestic savings in 1972-73 was 94.5 per cent. In other words, about five per cent of net investment had to be financed by foreign savings. The household sector which is the net saving sector in the economy and whose savings are used by the other two sectors in the economy, namely, Government and private corporate business, has, therefore, to be induced to increase its savings. Hence, savings media have to be created to suit the preferences of savers particularly in the household sector. These preferences depend on varying considerations such as liquidity, return, maturity and safety. To the extent that the savings are in forms like bank deposits, provident funds and insurance policies, it is easier to regulate their flow in planned directions.

2.13 As observed earlier, savers' preferences have recently been changing in favour of deposits with NBCs. The first question is whether this development will raise the total quantum of savings in the economy. Although no firm empirical evidence is available one way or the other, it will, by and large, be difficult to sustain the argument that the total level of savings of the household sector is responsive to changes in interest rates under Indian conditions. It has also been observed that structural changes in the Indian society have, over the last few years, produced a tendency towards higher consumption, at least among certain sections of the population. Among the important factors which have contributed to this trend are the increasing avenues of consumption and the impact of demonstration effect. The rapid erosion of purchasing power of money has put a further premium on current consumption. In the present state of rising prices, the level of interest rates prevailing in the organised sector of the economy is not adequate even to maintain the real value of investments in financial assets. It is, therefore, unlikely that even the comparatively high interest rates offered by companies on deposits will tempt the household sector to curtail its consumption expenditure and add to its savings. Apart from the relatively higher return, deposits with NBCs do not possess any other special characteristics which

may induce the households to go in for them by reducing their level of consumption expenditure. Therefore, the acceptance of deposits by NBCs is unlikely under existing circumstances to increase the total level of savings of the household sector.

2.14 This, however, does not imply that the structure of interest rates does not influence the distribution of savings among different instruments of savings. With the exception of life policies and provident funds which are contractual savings, deposits with NBCs compete with other financial assets in the portfolio of the households. Of greater importance is the relevance of deposits with NBCs as a near-substitute for cash and bank deposits. To the extent that there is shift from cash as an asset in the portfolio of the household sector to deposits with NBCs, savings will be put probably to more productive uses. In the course of its discussions with various experts including some bankers, the Study Group was informed that there is evidence to show that recently there has been a shift from bank deposits to deposits with NBCs; in particular, new savings are tending to flow more to NBCs than to banks. This does not necessarily mean that, as a result, the growth of bank deposits would be slackened over a period. When bank deposits are shifted to NBCs, a change in the ownership structure of deposits with banks occurs. The companies use these deposits for meeting their expenditure or reducing their indebtedness by drawing on their bank accounts to which the deposits accepted from the public are also credited. In this process, it is quite likely that over a period the level of deposits of the banking system may remain almost unchanged or may be reduced negligibly by the amount of cash in hand that these companies might wish to keep. As pointed out by a Study Group* appointed by the National Credit Council, "... these company deposits would find their way into the banking system via tax payments, payments to creditors or as working balances of companies; the diversion, if any, could not be more than the share of currency in the total monetary resources. In other words, while there would be some diversion, it would not be correct to regard the total magnitude of non-banking deposits as being lost to the banking system. If anything, therefore, to the extent that such deposits activised a currency hoard, they tend to increase the overall resources of the banking system". A similar view has been expressed in the Report of the Banking Commission@. Thus, while the total level of savings is unlikely to increase on account of the deposits flowing to NBCs, the pattern of savings would undergo a change. There will also be a shift in the ownership of bank deposits from the household sector to the corporate sector.

IMPLICATIONS FOR MONETARY AND CREDIT POLICY

2.15 This change in the ownership pattern of bank deposits has important

* Report of the Study Group on Deposit Mobilisation by Commercial and Co-operative Banks (1969); paragraph 35.

@ See Report of the Banking Commission (1972); paragraph 6.46.

implications for the monetary and credit policy of the Reserve Bank. Assuming that the deposits with NBCs take the form only of a shift from bank deposits, there will be hardly any increase in the total expenditure in the economy. The expenditure, however, will increase if the cash holdings of the household sector are placed as deposits with NBCs. The growing volume of deposits with these companies affects the operation of monetary and credit policy to the extent that it involves a loss of direct control on the use of these funds. If the companies borrow from commercial banks or other lending institutions in the organised sector, they have to satisfy the requirements laid down by the lenders. These requirements are governed by considerations of credit policy as well as the safety of funds lent out by the institutions. Hence, a scrutiny of the plans for expansion or inventories and financial performance of the borrower is usually undertaken, firstly by the banks and in the case of larger accounts by the Reserve Bank under the Credit Authorisation Scheme. NBCs do not have to satisfy any such requirements when they approach the public for deposits. For instance, deposits from the public may make it possible for a company to hold for a time stocks higher than what the monetary authorities allow through their control over bank lending. The efficacy of the selective credit controls is diluted if the companies are enabled to meet the margin requirements for borrowings from commercial banks through the deposits accepted from the public. Non-banking financial intermediaries (NBFIs) may also give loans to borrowers dealing in commodities covered by selective credit controls.

2.16 So far as the effect of the acceptance of deposits by the corporate sector on the pattern of investment is concerned, it would depend upon (a) the distribution of the incremental deposits between the various non-banking non-financial companies and non-banking financial companies, (b) the inter-company distribution of deposits, and (c) the lending pattern of NBFIs.

2.17 What emerges from the above discussion is that, although the total savings in the economy are not likely to increase on account of increased deposits with NBCs, the pattern of savings and investment in the economy is likely to undergo changes. So far as the effect of these deposits on the working of monetary and credit policy is concerned, while the total expenditure may not increase much on account of the acceptance of deposits by NBCs, the pattern of expenditure may be somewhat different from the desired directions. On the other hand, it is possible to overstate the dilution of monetary policy on account of the acceptance of deposits by NBCs. First, as pointed out earlier, the magnitude of these deposits is still not very large in comparison with bank deposits. Secondly, if commercial banks take into consideration the deposits accepted by non-financial companies while determining their credit limits, the total effect on expenditure may be negligible. So far as non-banking financial companies (NBFCs) are

concerned, the ultimate destination of their funds is even more difficult to ascertain than in the case of non-financial companies. Whereas in the case of the latter, the borrowerwise destination of deposits is known, it is not easy to ascertain it in the case of loans given by the former. Hence, there is a greater likelihood of the dilution of monetary policy through the operations of NBFIs than the acceptance of deposits by non-financial companies. Finally, in making a judgement about the desirability or otherwise of the acceptance of deposits by NBCs, due weightage has to be given to difficulties faced by companies in carrying out their normal productive operations. It would no doubt be ideal to have a system under which banks and other financial institutions fully satisfy the varying saver and borrower preferences and operate in consonance with social objectives. However, in the evidence tendered before the Study Group even by bankers, it was agreed that this ideal situation is still to be achieved. Also nothing should be done which will worsen the investment climate. Hence, in the view of the Group, the current situation calls for a regulation but not prohibition of the acceptance of deposits by NBCs. Nevertheless, the long run objective should be to bring about a progressive reduction in the quantum of deposits with non-banking non-financial companies.

2.18 The approach to NBFCs which accept deposits for making loans and advances will have, however, to be different because these institutions are like banks. Since commercial banks are spreading their branches extensively and are introducing schemes to cater to the requirements of even the neglected sectors of the community, the usefulness of NBFCs in the economy will have to be carefully examined. Since these institutions vary greatly in the nature of their operations, the Study Group has examined important types of NBFCs separately and taken a selective approach to the regulation of their activities.

REGULATION OF DEPOSITS WITH NBCs AND PROTECTION OF DEPOSITORS' INTERESTS

2.19 While the primary object of regulation of acceptance of deposits by NBCs is to keep the magnitude of these deposits within limits and to encourage their flow into desired channels, the protection of depositors' funds is also important. In the course of evidence tendered before the Group, a number of cases were pointed out where the depositors had lost their savings by placing them as deposits with NBCs. The main reason for the default in repayment of deposits by NBCs was that they had accepted deposits out of proportion to their capacity to repay them at maturity. In several cases, short-term deposits were used for the purpose of fixed capital formation. Although quantification of the magnitude of defaults is difficult, judged by the number of complaints received in recent years, there is no doubt that the incidence of defaults has increased with the increase in the

number of companies soliciting deposits as also in the magnitude of deposits. Even those companies, which were not accepting deposits as a regular source of finance earlier, have entered the field in recent months. As already pointed out, the lure of high interest rates combined with aggressive canvassing by brokers on behalf of the companies has induced many depositors to put their moneys with NBCs. Some of the unscrupulous NBCs have taken full advantage of the situation and overtraded with the deposits that they mobilised from the public.

2.20 The major element in the regulation of deposits from the viewpoint of safeguarding the interests of the depositors has so far been to make it obligatory on the part of the deposit-accepting companies to disclose relevant information about their management and financial position in their advertisements. The rationale of the philosophy of disclosure has been that the depositors would be able, on the basis of this information, to assess the risk attached to these deposits with NBCs. However, there is a general feeling that the disclosure of information by NBCs has not been sufficient to protect depositors' interests mainly because not all the depositors are able to appreciate the implications of the information furnished to them. Strong representations were, therefore, made to the Group to consider more effective measures to ensure the safety of deposits with NBCs. In the view of the Group, however, the safety of deposits with NBCs cannot be put at par with that of commercial banks. The high interest rates paid by NBCs to the depositors reflect the greater risk attached to such deposits. Ordinarily the lower the risk, the lower is the return on savings and *vice versa.* The point is that it is the varying mix of maturity, yield, return and risk which differentiates between different savings media. Moreover, the element of risk attached to different savings media cannot be brought to an absolute parity. Within these limitations, the recommendations made by the Group seek to minimise the risk attached to deposits with NBCs.

2.21 In making its recommendations, the Group has examined the existing regulations pertaining to the activities of NBCs in selected foreign countries. The information* collected by the Group relates particularly to NBFIs. By and large, following are the main features of the regulations:

(i) For acceptance of deposits, licence from the authority is required.

(ii) The issue of advertisements is regulated.

(iii) A minimum period for acceptance of deposits is prescribed.

(iv) A minimum amount of paid-up capital and/or a minimum ratio between owned funds and total liabilities is/are prescribed.

(v) Authorities are empowered to make rules prescribing rates of interest

* See Appendix V.

to be paid by NBFIs on public deposits. In a few countries, the policy has been to keep the return on Government securities attractive to the public and interest rates payable on bank deposits competitive with those offered by NBFIs.

(vi) The proportion of liquid assets and risk assets to the total is regulated.

(vii) There is a ceiling on unsecured advances to individual customers and the granting of loans to directors is prohibited.

(viii) Provision is made for the nomination of directors on the Boards of NBFIs.

(ix) Powers are vested in the authorities for compulsory winding up of NBFIs.

2.22 In making its recommendations on regulating the acceptance of deposits by NBCs, the Group has made a distinction between non-banking non-financial companies and NBFCs. The reason, as explained earlier, is that the latter are para banks whose activities consist of accepting deposits for the purpose of making loans and advances, unlike the manufacturing and trading companies which normally accept deposits for use in their own business. Since NBFCs belong to the genre of commercial banks, their activities have to be regulated broadly on the same lines as those of commercial banks.

2.23 To sum up, the Study Group has made its recommendations for the regulation of deposits with NBCs with a view to ensuring that, while their magnitude is kept within reasonable limits, they subserve the objectives of monetary and credit policy and that a larger degree of protection is afforded to the depositors' interest. The Group has also given weightage to the administrative feasibility of the suggestions made by it.

CHAPTER 3

EVOLUTION OF THE REGULATIONS GOVERNING ACCEPTANCE OF DEPOSITS BY NBCs

GENESIS OF THE REGULATIONS

3.1 With the spurt in the tempo of economic development in the country since the fifties as a result of the launching of the Five-Year Plans and in particular the Second Five-Year Plan, it was observed that the activities of NBCs had increased and that they had commenced accepting deposits from the public by offering attractive rates of interest to finance their business. Since commercial banks did not cater to the needs of some sections of the community such as small transport operators and retail trade and did not extend credit to certain types of household expenditure, financial companies stepped up their activities in these fields. Further, due to the general policy of credit restraint and the enforcement of selective credit control measures by the Reserve Bank, NBCs found it advantageous to meet part of their requirements for funds by mobilising deposits from members of the public. In the absence of any regulation of acceptance of deposits by NBCs, several unhealthy features came to the surface in the sixties when a sharp increase in the volume of deposits held by such companies was also noticed. Non-financial companies and later financial companies began to issue advertisements soliciting deposits from the public, offering lucrative rates of interest but without giving any particulars regarding their financial position and management. Such unfettered growth of deposits outside the banking system and the proliferation of institutions, both financial and non-financial, depending mainly or wholly on deposits from the public were viewed with concern by the authorities. In the interests of depositors also, it was considered desirable that these institutions should not have unlimited and unrestricted access to public funds.

AMENDMENT OF THE RESERVE BANK OF INDIA ACT, 1934

3.2 Against this background, it was felt necessary by the authorities to have statutory control over acceptance of deposits by non-banking institutions and to vest the Reserve Bank, as the custodian of the monetary and credit system of the country, with certain powers enabling it to effectively supervise, control and regulate the deposit-acceptance activities of such institutions. Accordingly, the Reserve Bank of India Act, 1934 was amended by the Banking Laws (Miscellaneous Provisions) Act, 1963 whereby a new Chapter IIIB containing "Provisions relating to non-banking institutions

receiving deposits and financial institutions" was inserted in the principal Act.

OBJECTIVES UNDERLYING THE LEGISLATION

3.3 In the Statement of Objects and Reasons appended to the Banking Laws (Miscellaneous Provisions) Bill, 1963 it was stated as under:

> "The existing enactments relating to banks do not provide for any control over companies or institutions, which, although they are not treated as banks, accept deposits from the general public or carry on other business which is allied to banking. For ensuring a more effective supervision and management of the monetary and credit system by the Reserve Bank, it is desirable that the Reserve Bank should be enabled to regulate the conditions on which deposits may be accepted by these non-banking companies or institutions. The Reserve Bank should also be empowered to give to any financial institution or institutions directions in respect of matters in which the Reserve Bank, as the central banking institution of the country, may be interested from the point of view of the control of credit policy. . . ."

While moving the said Bill in the Lok Sabha* on December 19, 1963, the then Hon'ble Minister of Planning observed as follows:

> "...deposits which are now received and handled outside the banking system, should be controlled, not only in the interests of the depositors themselves, but also in the general and wider public interest. We also intend that the activities of loan, investment and hire-purchase companies or firms, or other financial institutions, which grant loans and advances for a variety of purposes, or to purchase securities or shares and thereby influence or affect the money and capital markets, should be controlled by the central bank of the country, so far as these activities are concerned...."

The Hon'ble Minister also stated in the course of his speech in the Rajya Sabha@ on December 23, 1963, as under:

> ". . . Central banking traditions, or any other traditions for that matter, cannot be rigid; and in a country in which the commercial banking system is not sufficiently developed or important, we cannot obviously be wedded to conservative British traditions as they were evolved several years ago. We have to take into account local needs and circumstances, and if it becomes necessary to control deposits outside the banking system or the loans, investments or other allied business of non-banking

* See pp. 5681-2 of Lok Sabha Debates, Third Series—Vol. 24—Dec. 16-21, 1963.
@ See pp. 4771-2 of Rajya Sabha Debates, Vol. 45—Dec. 5-23, 1963.

institutions, we may be failing in our duty, if we do not bring our laws or enactments up to date.

As far as the control of non-banking deposits is concerned, this Bill, Sir, contains no provision which, I think, will not be found in the Protection of Depositors Act, 1963, which was recently brought into force in the United Kingdom. Broadly, what we are aiming at is that apart from individual money-lenders, who are governed by the various State enactments relating to money-lending, and co-operative societies, which are a class by themselves, all persons or institutions accepting deposits from the public will have the obligation to comply with the regulations, which will be made for this purpose by the Reserve Bank. It is not our intention to harass the small firms or partnerships, and firms with a subscribed capital which is not in excess of a lakh of rupees, have been exempted as a result of an amendment which we have accepted in the other House.

As regards other persons or institutions, we hope that the Reserve Bank will be able to prevent malpractices, if any, to stop unhealthy competition for deposits, and to prescribe and enforce reasonable conditions, including realistic rates of interest, disclosure of any information or particulars in which the depositors may be interested, provision for returning the money to them in certain contingencies, and other relevant matters.

As regards loan, investment and hire-purchase companies, or corporations or firms carrying on similar activities, we are proposing that the Reserve Bank should be in a position to get a fuller and more comprehensive picture of their activities than is now possible, to lay down certain uniform rules and standards as regards rates of interest on which loans may be granted or investments may be made and to give special directions regarding the functions and operations of these financial institutions, in so far as this may be necessary for the better regulation of the country's credit policy. Here again, we have accepted a clarificatory amendment of the definition of a financial institution in clause 5 of the Bill, so as to make it clear that we intend to control only those institutions which handle money or securities or other titles to money. In an undeveloped country, in which the normal methods of controlling or liberalising credit through the established commercial banks are not effective, the central bank has to be granted this specific authority, and I have no doubt that ultimately the results will justify this extension of the Reserve Bank's jurisdiction and functions."

3.4 From the foregoing, and other relevant factors mentioned earlier, it would be evident that the scheme of control over acceptance of deposits by

NBCs from the public was conceived mainly as an adjunct to the monetary and credit policy of the country while affording a degree of protection to the depositors' funds.

GIST OF THE PROVISIONS OF CHAPTER IIIB OF THE RESERVE BANK OF INDIA ACT, 1934

3.5 It may now be useful to deal briefly with the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934, which came into force with effect from February 1, 1964. A non-banking institution was defined as a company, corporation, co-operative society or a firm as defined in the Indian Partnership Act, 1932, of which the capital subscribed by its partners exceeds one lakh of rupees. By virtue of the aforesaid provisions, the Reserve Bank has been vested, *inter alia,* with the following powers—

(i) To regulate or prohibit the issue of any prospectus or advertisement by any non-banking institution soliciting deposits of money from the public.

(ii) To call for statements, information or particulars from non-banking institutions relating to or connected with deposits accepted by them, including rates of interest payable, the purposes and periods for which, and other terms and conditions on which deposits may be received.

(iii) To give directions, if the Bank considers necessary in the public interest so to do, to non-banking institutions either generally or to any non-banking institution or group of non-banking institutions in particular, in respect of any matters relating to or connected with the receipt of deposits, including the rates of interest payable on such deposits, and the periods for which deposits may be received.

(iv) To prohibit any non-banking institution from accepting deposits if it fails to comply with any direction given by the Bank, referred to above.

(v) To compel a non-banking institution receiving deposits, if so required by the Bank and within such time as the Bank may specify, to send a copy of its annual balance sheet and profit and loss account or other annual accounts to every person from whom the non-banking institution holds as on the last date of the year to which the accounts relate, deposits higher than such sum as may be specified by the Bank.

(vi) To call for information/statements from financial institutions relating to their business, including information in respect of their paid-up capital, reserves and other liabilities, investments made and advances granted and the terms and conditions including rates of interest, on which the advances are granted.

(vii) To give to financial institutions either generally or to any such institution in particular, directions relating to the conduct of business, having

due regard to the conditions in which, and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect which its business is likely to have on trends in the money and capital markets.

(viii) To inspect any non-banking institution for certain specified purposes.

(ix) To prosecute institutions and/or persons concerned, for failure to comply with the directions issued by the Reserve Bank and/or wilful submission of incorrect or incomplete information.

3.6 It will be seen from the foregoing that the provisions contained in Chapter IIIB of the Reserve Bank of India Act empowered the Bank for the first time to regulate acceptance of deposits by NBCs, corporations, co-operative societies and partnership firms with subscribed capital exceeding Rs 1 lakh. However, for administrative reasons, the directions issued by the Bank cover only companies as defined in section 3 of the Companies Act, 1956 including foreign companies within the meaning of section 591 of the said Act.

ISSUE OF ORDERS/DIRECTIONS

3.7 With a view to evolving appropriate regulatory measures, the Reserve Bank issued certain orders in May 1964 and 1965 respectively requiring NBCs to furnish it in the prescribed forms with certain information relating to or connected with their deposits from the public and other business allied to banking. On the basis of the information collected, the Bank issued certain directions in January 1966, in the first instance, to non-financial and hire-purchase finance companies. These directions were replaced by two sets of new directions issued on October 29, 1966 to financial and non-financial companies, called the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966* respectively which came into force from January 1, 1967.

3.8 Of late, there has been a large increase in the number of companies collecting funds from the public by way of subscriptions to the various prize chit or benefit schemes floated by them and holding lucky draws. Since it was found that cases of such type of companies had not been adequately covered by the existing directions issued to financial companies, the Reserve Bank issued a new set of directions called the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 on August 23, 1973 which was brought into force from September 1, 1973.

* These directions issued to non-financial companies were withdrawn by the Reserve Bank with effect from June 3, 1975 in view of the framing of the Companies (Acceptance of Deposits) Rules, 1975—see paragraph 3.20.

SALIENT FEATURES OF THE DIRECTIONS

3.9 A tabulated statement outlining the salient features of the three sets of directions issued by the Reserve Bank to financial, non-financial and miscellaneous non-banking companies respectively, as amended up to January 27, 1975 is appended@. It will be seen therefrom that the directions, besides exempting certain types of moneys received by NBCs from their purview, provide for the following:

(i) they prohibit acceptance of short-term deposits by NBCs for periods of less than six months. (Non-banking non-financial companies were, however, allowed to accept deposits by way of unsecured loans guaranteed by directors, shareholders' deposits, etc., for periods of not less than three months to the extent of 10 per cent of their net owned funds to meet their seasonal requirements for funds);

(ii) they restrict acceptance of deposits and unsecured loans to two ceilings of 25 and 15 per cent respectively of the net owned funds in respect of two categories of deposits, viz., conventional deposits and unsecured loans guaranteed by directors, deposits from shareholders, etc., in the case of all NBCs except two types of NBFCs, viz., hire-purchase finance and housing finance companies. These two categories of NBFCs are, however, required to maintain a minimum percentage of liquid assets (by way of cash with themselves or in current or any other deposit accounts with scheduled banks free from any charge or lien or in unencumbered securities of the Central Government or of a State Government or in other unencumbered securities in which a trustee is authorised to invest trust money) of not less than 10 per cent of the deposits outstanding in the books of the companies concerned on any day; further, hire-purchase finance companies have to ensure that hire-purchase debts are collected within a reasonable period in the manner stipulated in the relative provisions of the directions;

(iii) NBCs are required to disclose particulars regarding their management, business, profits/losses, dividends, etc., in any advertisement soliciting deposits and in the application forms for acceptance, renewal or conversion of deposits;

(iv) NBCs have to furnish proper receipts for deposits to the depositors and maintain registers in regard to deposits with certain prescribed particulars;

(v) NBCs are required to include in their annual reports certain specified particulars regarding overdue deposits; if such overdue deposits are, in the aggregate, in excess of Rs 5 lakhs, a statement on the steps taken or proposed to be taken by the Board of Directors for payment of the amounts due to the depositors and remaining unclaimed or undisbursed has to be included in the annual report; and

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@ See Appendix VI.

(vi) NBCs have to submit their balance sheets and the profit and loss accounts as also returns in the prescribed schedules to the Reserve Bank within the time stipulated in this behalf. All NBCs are also required to furnish to the Bank within the specified time, certain other particulars such as the names and designations of their principal officers, the names and residential addresses of their directors, and also intimate the changes, if any, in this regard.

AMENDMENTS TO THE DIRECTIONS

3.10 The directions referred to above have been amended from time to time with a view to plugging certain loop-holes which came to the Bank's notice during the course of the administration of the directions, and also to relax certain provisions thereof where they were considered to be unduly restrictive. Thus, unsecured loans raised by companies against the guarantees given by their directors, which had earlier been excluded from the purview of the directions were, with effect from January 1, 1972, subjected to the same ceiling restrictions as applicable to deposits when it was found that the exemption was being abused. On the other hand, inter-company deposits and deposits received by private companies from their shareholders were, subject to certain conditions, exempted from the purview of the directions with effect from January 1, 1973. Deposits secured by mortgage, pledge or hypothecation, etc., of the assets of a company were, till the end of August 1973, completely exempt from the directions. However, with effect from September 1, 1973, such deposits have been made eligible for exemption only from the ceiling restrictions if certain conditions regarding the nature of security and margin are fulfilled; in other respects such as advertisements, the companies are required to comply with the relative directions.

3.11 Mention may also be made at this stage of the recent amendments made to the above three sets of directions. Under the directions issued to non-banking non-financial and financial companies, which came into force from January 1, 1967, such companies could accept deposits to the extent of 25 per cent of their paid-up capital and free reserves—subsequently, clarified as 25 per cent of the paid-up capital and free reserves as diminished by the balance of accumulated loss, if any (net owned funds). However, deposits in the form of unsecured loans guaranteed by directors, deposits raised from shareholders, etc., were exempt from the purview of the directions. With effect from January 1, 1972, the latter category of unsecured loans/ deposits was also brought within the purview of the directions and a separate ceiling of 25 per cent of the net owned funds was prescribed in respect thereof. Companies holding the latter category of deposits in excess of 25 per cent were required to wipe off such excess as on the date of coming into operation of the amendment in a phased manner before April 1, 1975.

3.12 Effective from January 27, 1975, the ceiling of 25 per cent in respect

of deposits in the form of unsecured loans guaranteed by directors, deposits raised from shareholders, etc., has been reduced to 15 per cent of the net owned funds of the company. Non-banking non-financial and financial companies holding deposits in excess of 15 per cent of their net owned funds are required to wipe off the excess by December 31, 1975. Miscellaneous non-banking companies conducting prize chits, benefit/savings schemes/ lucky draws as also those conducting conventional chits, which have been allowed time up to September 30, 1976 under the relative directions to wipe off the excess, if any, of the aforesaid types of loans over the existing ceiling of 25 per cent, are now required to bring down their outstandings in respect of such guaranteed loans, shareholders' deposits, etc., within the reduced ceiling of 15 per cent by December 31, 1976.

3.13 Thus the current position in regard to ceiling restriction on deposits accepted by NBCs is as follows. No NBC can accept deposits exceeding 40 per cent of its paid-up capital and free reserves less balance of accumulated loss, if any. Within the ceiling of 40 per cent, it can accept 25 per cent from the public and 15 per cent from shareholders or by way of deposits guaranteed by directors, etc. There are no ceilings on deposits accepted by hire-purchase and housing finance companies.

SALIENT FEATURES OF THE STATUTORY RETURNS PRESCRIBED UNDER THE DIRECTIONS

3.14 The directions issued to non-banking non-financial, financial and miscellaneous non-banking companies make it obligatory on them to submit returns containing the required information to the Reserve Bank in the prescribed forms applicable to them. A non-banking non-financial company which holds deposits as on March 31 in any year has to submit the return to the Bank by June 30 with reference to its position as on March 31. However, a non-banking financial company has to furnish the return in the form applicable to it irrespective of the fact whether it holds any deposits or not. A miscellaneous non-banking company has to submit the return twice a year before June 30 and December 31 with reference to its position as on March 31 and September 30 irrespective of the fact whether it holds any deposits or not.

3.15 The information required to be furnished in the prescribed returns relates to deposits outstanding in respect of the relative ceilings referred to earlier and exempted borrowings and receipts, e.g., security deposits, which do not fall within the purview of the definition of the term "deposit". Period-wise break up of deposits, the rates of interest thereon and the number of accounts in respect of each category of deposits are also required to be given. Financial companies have to give additional information relating to their loans and advances outstanding, classified by types of borrowers, by security

and by purpose of the advances. Further, particulars regarding investments classified by status of borrowers, investments in shares, debentures and other securities have also to be furnished. Hire-purchase finance and housing finance companies have to give particulars regarding the liquid assets maintained by them and hire-purchase finance companies have to give information about the recoveries of hire-purchase debts for the purpose of compliance with the directions.

3.16 The purpose of prescribing the statutory returns is two-fold. First, it enables the Reserve Bank to verify how far the companies concerned comply with the directions and take necessary action if there is a contravention thereof. Secondly, it enables the Bank to watch the trend of deposits and take suitable action either for tightening the provisions of the directions or for relaxing them as the circumstances warrant. The information collected through the surveys is analysed and an article based on the analysis is published annually in the Reserve Bank Bulletin.

FURTHER AMENDMENTS TO THE RESERVE BANK OF INDIA ACT, 1934

3.17 The provisions of Chapter IIIB of the Act were further amended by the Reserve Bank of India (Amendment) Act, 1974 with a view to plugging certain loopholes in the existing provisions thereof, vesting the Reserve Bank with better powers to exercise control over non-banking institutions receiving deposits. The important provisions of the Amending Act, which came into force with effect from December 13, 1974, relate to the under noted matters:

(i) The term 'deposit' has now been defined in the principal Act itself as including and "deemed always to have included, any money received by a non-banking institution by way of deposit, or loan or in any other form, but shall not include amounts raised by way of share capital or contributed as capital by partners of a firm". Further, the existing definition of the term 'financial institution' has been amplified to make it more comprehensive and precise.

(ii) It has been made statutorily obligatory on the part of the auditor of a non-banking institution to enquire whether or not it has furnished to the Reserve Bank returns and other information required to be furnished under the directions issued by the Bank and in case a non-banking institution has failed to do so, to make a report to the Bank giving the aggregate amount of such deposits held by the non-banking institution.

(iii) The powers of the Reserve Bank for conducting inspections of non-banking institutions have been widened; under the amended provisions, the Bank can inspect a non-banking financial institution whenever such an inspection is considered by it 'necessary or expedient'.

(iv) A new section inserted in the principal Act seeks to prohibit circumvention by brokers of the existing provisions relating to the particulars to be specified in prospectuses or advertisements soliciting deposits from the public and to make it compulsory not only for the companies but also for the brokers to disclose full particulars and information about non-banking institutions concerned while canvassing for deposits.

(v) Enhanced penalties have been provided for contravention of the relative provisions of the Act and the directions issued thereunder to non-banking institutions.

AMENDMENTS TO THE COMPANIES ACT, 1956

3.18 The Companies (Amendment) Act, 1974 has come into force with effect from February 1, 1975. This Act has introduced, *inter alia,* two new sections in the principal Act which empower the Central Government to regulate acceptance of deposits by NBCs in consultation with the Reserve Bank. Prior to the said amendments, the deposit-acceptance activities of all types of NBCs—whether non-financial, financial or miscellaneous non-banking —were regulated by the respective set of directions* issued to them by the Reserve Bank in exercise of the powers vested under Chapter IIIB of the Reserve Bank of India Act, 1934. However, with the coming into operation of the said Amendment Act, the acceptance of deposits by non-banking non-financial companies from the public or from their members is regulated by sections 58A and 58B and the rules made in this behalf.

3.19 Section 58A stipulates, *inter alia,* that the Central Government may, in consultation with the Reserve Bank, prescribe the limits up to which, the manner in which, and the conditions subject to which, deposits may be invited or accepted by a company either from the public or from its members. Besides, no company can invite or allow any other person to invite any deposit unless the invitation for such deposits is in accordance with the rules made under the section and unless an advertisement including therein a statement showing the financial position of the company has been issued by the company in the form and manner prescribed by the rules. The section also casts an obligation on the company to repay on or before April 1, 1975 the deposits accepted in violation of the directions issued by the Reserve Bank and those accepted in violation of the rules, within thirty days from the date of acceptance or such extended time not exceeding thirty days as may be allowed by the Central Government. It has also been provided that deposits accepted in conformity with the Reserve Bank directions shall be repaid in accordance with the terms of such deposits unless renewed in accordance with the rules. The section further prescribes deterrent penalties for non-repayment of deposits accepted in contravention of the Reserve Bank directions or the

* See Appendix VI.

rules and also for invitation or acceptance of deposits in contravention of the rules. In terms of section 58B, the provisions of the principal Act relating to a prospectus shall, so far as may be, apply to an advertisement referred to in section 58A *ibid.*

3.20 Pursuant to the said section 58A read with section 642 of the Companies Act, 1956, the Central Government has made rules called the Companies (Acceptance of Deposits) Rules, 1975 which have been brought into force with effect from February 3, 1975. The rules broadly follow the pattern of directions issued by the Reserve Bank to non-financial companies*. The salient points of difference between the said directions and the rules and our suggestions for further amendment of the rules in the context of our recommendations are indicated in the next chapter.

3.21 With the coming into operation of the Companies (Acceptance of Deposits) Rules, 1975, an element of dichotomy has been introduced in this regard inasmuch as the acceptance of deposits by non-banking non-financial companies is regulated by the said Rules by the Company Law authorities whereas the regulation of deposit-acceptance activities of non-banking financial companies and miscellaneous non-banking companies is the responsibility of the Reserve Bank. The question of co-ordination between the two authorities in the exercise of their powers in this regard is discussed in Chapter 7.

* See column 2 of Appendix VI.

CHAPTER 4

NON-BANKING NON-FINANCIAL COMPANIES

INTRODUCTION

4.1 In this chapter, we propose to deal with the various aspects of the deposit-acceptance activities of non-banking non-financial companies. Deposits with non-financial companies account for nearly two-thirds of the total deposits held in the non-banking corporate sector. The term "non-banking non-financial company" had been defined in the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966, to mean any company which is not a hire-purchase finance, housing finance, insurance, investment, loan, miscellaneous financial, mutual benefit financial, stock exchange or stock-broking company. In other words, all companies which were not financial companies were treated as non-financial companies for the purposes of the directions. We propose to treat the term "non-financial company" in the same connotation in which it had been used in the directions referred to above. In popular parlance, the term "non-financial company" would cover industrial, manufacturing and trading companies.

DEPOSITS AS RESOURCES FOR NON-FINANCIAL COMPANIES

4.2 In a broad sense, there are five recognised means of raising finance by companies. These are—

(a) issue of equity and preference shares,

(b) issue of debentures—secured or clean,

(c) borrowings from banks and other financial institutions,

(d) issue of convertible bonds, and

(e) acceptance of deposits from the public (including directors, shareholders, etc.).

Of these, the first four are subject to varying degrees of control and discipline of authorities such as the Controller of Capital Issues, commercial banks and/or term-lending institutions; the control takes the form of prior scrutiny of the feasibility/viability of the proposals, financial position of the companies concerned, etc. In the case of deposit-acceptance, the directions issued by the Reserve Bank or the Companies (Acceptance of Deposits) Rules, 1975 regulate only certain aspects of the acceptance of deposits by imposing restrictions on the total quantum of deposits which may be accepted, requiring

the companies to disclose certain particulars in their advertisements, etc; there is, however, no scrutiny of the financial position or the need-based requirements of the deposit-accepting companies by the authorities.

4.3 Regarding the justification for acceptance of deposits by NBCs, it was contended before the Group by the various Chambers of Commerce and Industry as also certain other organisations representing trade and industry that acceptance of deposits by companies to supplement their needs and requirements of working capital has been a traditional source of finance in our country. They were of the view that in so far as these deposits promote the basic purpose of inducing larger savings and directing them towards productive activity, they serve the larger policy objective of maximising production. It was further pointed out by them that deposits have played a prominent role even in the financing of fixed assets in some cases and that the textile industry in Ahmedabad and Coimbatore owes its present position to the financing of the industry by way of deposits taken from the public. Certain other advantages in regard to the acceptance of deposits by non-financial companies from the public stressed before the Group are enumerated below:

(i) The lenders get what the borrowers pay. The reward for financial intermediaries is eliminated, this being shared by the creditor and the debtor. The resulting higher rates of interest on deposits encourage savings.

(ii) The companies get easy and timely credit at rates lower than those charged by banks.

(iii) The deposits find immediate application; production bottle-necks for want of liquid funds are avoided.

(iv) Since deposits with companies have no money-creating power, they will not have the effect of expanding money supply through the pyramiding process.

4.4 It was stated in the evidence submitted to the Group that the enormous increase in the cost of raw materials due to inflation in the economy, and the inability of the banking system to meet the entire credit requirements of the industry and trade, left manufacturing and trading companies with no option but to mobilise deposits in a big way during the last few months, i.e., from about the middle of 1974 onwards. Due to the restrictions on payment of dividends under the Companies (Temporary Restrictions on Dividends) Act, 1974, the market for new issues of equity capital has been reduced to a state of near paralysis and it is impossible for even prosperous companies with a good dividend record to augment their resources by way of equity capital. The market for new issues of preference capital has in any case been supported during the last few years only by financial institutions. Furthermore, since the term-lending institutions are facing resource constraints, long-term

borrowing is also becoming difficult. This situation has coincided with a steep increase in the rates of interest charged by the commercial banks on the normal borrowings for working capital purposes; the requisite amount of funds is not available even at high rates of interest of 16 to 18 per cent per annum. It was pointed out to the Group by several organisations that in these circumstances the mobilisation of deposits directly from the public was relatively cheaper for the companies and offered a way out of the current difficulties of raising funds by other means. It was also submitted that under normal conditions, trade and industry would consider credit facilities from banks as a more dependable source of finance for meeting their requirements than raising finance by way of deposits, which may pose problems of their own. While banks could be expected to be sympathetic in the recovery of their advances, adverse working results of a company in any particular year due to circumstances beyond its control might cause a scare among the depositors and there could be a rush for repayment of the deposits. Further, the adverse working results would simultaneously impair the ability of a company to borrow by way of deposits by bringing down the aggregate of its net owned funds, thus making it eligible only for a reduced ceiling or rendering it ineligible to borrow by way of deposits. However, it is only in such eventualities that the company would be more in need of funds than when its financial position was better.

4.5 The opposite point of view which was urged before the Group by some organisations and individuals was that mobilisation of deposits by non-financial companies should be regarded as undesirable. In their view, such mobilisation leads to a diversion of deposits from the organised banking sector. Instances of such diversion were cited before us. It was also stated that the funds so raised were often utilised by companies for meeting margin requirements stipulated by banks on their advances, thus defeating the purpose underlying the credit control measures. Furthermore, it was contended that public deposits were being used, particularly by trading companies, for speculative hoarding of commodities, which caused inflationary pressures; since the end-use of such funds cannot be easily controlled, they are likely to be diverted into non-priority sectors and used for unproductive purposes.

4.6 While the arguments advanced for and against the necessity and justification for acceptance of deposits by non-financial companies have merits of their own, the consensus of opinion as put forward before the Group was that the present situation in which there has been a spurt in the soliciting of deposits from the public is an abnormal one brought about by a combination of temporary factors. It is evident that in the present abnormal conditions in the economy, non-financial companies are, to some extent, not getting sufficient funds from banks to meet their working capital needs. There is also some force in the point made out by a few organisations that deposit mobilisation by non-financial companies represents to some extent an

activisation of idle cash. It would not, therefore, be correct to regard the entire amount of deposits mobilised by NBCs as a diversion from banks.

4.7 As regards its broad approach to the problems posed by public deposits with non-financial companies, particularly the increase in their magnitude recently, the Study Group is of the view that measures in regard to these deposits must be designed to ensure the efficacy of monetary and credit policy and to avoid disruption of the productive process, consistent with the need to safeguard, to the extent possible, the depositors' interests. At the same time, the ultimate objective should be to discourage the further growth of these deposits and to roll them back gradually so that they would cease to be a significant source of finance for industry and trade. In the short run, some tolerance of public deposits is inevitable, but care should be taken to see that the interests of depositors are reasonably well protected.

4.8 Keeping the above objectives in mind, we may now turn to consider certain specific aspects of the regulation of these deposits.

SAFETY OF THE DEPOSITORS' FUNDS

4.9 The most important factors for ensuring the safety of depositors' funds are the soundness of the company and the quality and integrity of its management. The regulatory measures governing acceptance of deposits such as ceiling on the quantum of deposits, requirement as to disclosure of relevant particulars in the advertisements soliciting deposits and in the application forms to be filled in by the depositors, have been conceived to afford an indirect protection to the depositors by providing in-built safeguards and also to enable the prospective depositors to make an assessment of the financial position and management of the company with which they intend investing their funds. Yet they are not a complete answer in themselves in regard to the safety of the depositors' funds. In this context, the Group gave serious consideration to the question whether some sort of insurance cover on the lines of the cover offered by the Deposit Insurance Corporation in respect of deposits with commercial banks could be given in the case of deposits accepted by NBCs. In fact, a suggestion to this effect was canvassed by a good number of individuals/organisations. The Group is not in favour of the suggestion, partly because the risks to be insured would differ widely as between companies, some being in effect uninsurable, and partly because it would be conceptually wrong to confer on unsecured company deposits the same protected status as has been conferred on bank deposits. A degree of risk is an inevitable concomitant of higher rates of interest offered on company deposits. We have discussed these aspects in greater detail in the next chapter while dealing with the question of extending insurance cover to deposits with financial companies.

PERIOD OF DEPOSITS

4.10 Under the directions issued by the Reserve Bank to non-financial, financial and miscellaneous non-banking companies respectively as also under the Companies (Acceptance of Deposits) Rules, 1975, the minimum period for acceptance of deposits is six months. Non-financial companies have, however, been allowed to accept deposits to the extent of 10 per cent of their net owned funds for a period of not less than three months for meeting their short-term requirements, by way of unsecured loans guaranteed by directors, deposits from shareholders, etc., within the ceiling of 15 per cent in respect of such deposits. One view put forward before us was that the minimum period should be of a longer duration of, say, even two years; such a step would encourage a more careful planning of resources by companies, besides entailing "a little more conscientious judgement" on the part of depositors. It was further urged that this would emphasise the fact that acceptance of short-term deposits must essentially remain a function of the banking system. While the above arguments are *prima facie* valid, in our view, deposits should be used only to meet the short-term working capital requirements of non-financial companies and the prescription of a longer minimum period would induce the borrowing companies to invest such funds in fixed assets. It may be added that most of the respondents agreed that deposits accepted by NBCs from the public should be used only for working capital purposes.

4.11 Another point which may be noted in this connection is that under the directions issued to financial and non-financial companies as they stood prior to January 1, 1973, the minimum period prescribed for acceptance of deposits was twelve months in the case of all types of companies except hire-purchase finance and housing finance companies in whose cases the minimum period was six months. However, in view of the representations received by the Reserve Bank that the borrowing companies were put to an avoidable loss on account of payment of interest on deposits held for a duration longer than what was required for meeting their seasonal requirements, this minimum period was reduced with effect from January 1, 1973 to six months in the case of all types of companies (and in the case of non-financial companies, to a period of not less than three months in respect of deposits accepted by way of unsecured loans guaranteed by directors, shareholders' deposits, etc., up to 10 per cent of the net owned funds within the prescribed ceiling of 15 per cent). We are, therefore, of the view that the *status quo* in respect of the minimum period of deposits may be maintained.

4.12 As regards the maximum period of deposits, it was contended before us that no ceiling should be prescribed and that it should be left to the discretion of the borrowing companies. We are unable to accept this suggestion. As stated earlier, the finance raised by way of deposits is in the nature of short-term finance for meeting the working capital requirements of

companies; as such, the maximum duration of deposits should not, in our view, exceed three years. Such a ceiling would be desirable both in the interests of the borrowing companies as also the depositors. While the borrowing companies would, in the event of earlier maturity of the deposit liabilities, be vigilant to ensure some liquidity of funds for meeting their obligations, the depositors would be able to plan their investments to suit changing conditions. This would also ensure that the funds raised by way of deposits would neither assume the characteristics of demand deposits nor those of long-term finance obtained by other methods such as by issue of debentures or by way of term loans from financial institutions.

RATES OF INTEREST PAYABLE ON DEPOSITS

4.13 In the context of the recent aggressive mobilisation of deposits by non-financial companies by offering attractive rates of interest, it was strongly advocated by a section of the bankers that there should be a ceiling on the rates of interest which NBCs could pay on the deposits accepted by them and that these rates should not be more than 1½ to 2 per cent over the interest rates offered by banks on deposits for corresponding periods. It was pointed out that attractive rates of interest offered by NBCs result in a diversion of deposits from the banking system or at least a flow of new deposits to NBCs, which would have otherwise come to banks. According to this view, since restraints on extension of credit as also on the rates of interest on deposits are placed on commercial banks, it was not justifiable that NBCs should have a free hand in the matter of the rates of interest offered by them on deposits. A contrary view was expressed to the effect that the divergent interest rates, apart from varying with the period of deposits, also reflect the distinct characteristics of the companies and that even banks make a distinction between the various classes of borrowers in determining their lending rates.

4.14 In considering the above points, it may be noted that if our suggestion to prescribe a maximum period of 3 years for acceptance of deposits is implemented, the interest rates offered by non-financial companies on deposits would decline from the high levels presently offered by them on deposits of longer maturity. Also, since interest received by a depositor on company deposits is not eligible for tax concessions (vide paragraph 2.7), the actual return on such deposits to him may be less than the nominal rate of interest, the difference depending on his tax status. Another point which may be noted in this connection is the change made by the Finance Act, 1975, in the method of deducting tax at source. The previous position was that under section 194A of the Income-tax Act, any person not being an individual or Hindu undivided family was required to deduct income-tax at source from any interest (other than "Interest on securities") paid or credited to any person resident in India, where the amount paid or credited *at any one time*

exceeded Rs 400. Tax-payers were found to circumvent this provision by so arranging their affairs that interest income received by them at any one time did not exceed Rs 400 by splitting up the deposits or by receiving interest at periodical intervals. With a view to plugging this loophole, the Finance Act, 1975 provides that tax will be deducted at source from such income where the income credited or paid or likely to be credited or paid to the payee *in any financial year* exceeds Rs 1000. Although the possibility of circumvention of this provision by spreading deposits over a number of companies cannot be ruled out, it may have a disincentive effect on the growth of deposits with companies.

4.15 There is yet another aspect which has to be taken into account. Although the interest rates paid by companies on deposits are not controlled directly, they generally vary within a range between the maximum rates of interest allowed by banks on deposits and the minimum lending rates charged by banks depending on the financial position, management and reputation of the company concerned. [The interest rates on public deposits offered by NBCs currently (May 1975) vary from 9½ to 12 per cent for one year, 10 to 13 per cent for two years and 11 to 16 per cent for three years and over, with deposit/loans from shareholders or employees earning generally ½ per cent more]. In fact, the rates of interest allowed by banks act as a barometer for the rates offered by NBCs. Even if we were to suggest ceilings on rates of interest to be allowed by NBCs on their deposits, such ceilings could be circumvented by companies by offering other incentives such as prizes, bonus or even cash compensation through brokers or otherwise. In fact, one of the brokers who tendered evidence before us stated that out of the commission of 2 per cent received by him from companies, he has been making over ½ to 1 per cent to the depositors in cash by way of an additional incentive.

4.16 In the Finance Act, 1975, a provision has been made for the first time to the effect that 15 per cent of the expenditure by way of interest paid by non-financial companies on deposits received from the public will be disallowed in computing their taxable income. This will put up the cost of deposits accepted by non-financial companies. If, therefore, it is considered that the higher rates of interest offered by non-financial companies on their deposits adversely affect the structure of interest rates in the economy or the monetary and credit policy laid down by the authorities, the solution would appear to lie in similar fiscal measures intended to make borrowings by way of deposits more costly and less attractive as a source of finance. In any case, one of the main objects of the suggestion of prescribing maximum interest rates payable on deposits by non-banking non-financial companies, viz., to keep the quantum of such deposits within reasonable limits, will be served by our recommendation (see paragraphs 4.36 and 4.37) for fixing ceilings on such deposits and their reduction over a period of time. Such ceilings on deposits would also indirectly help in protecting the depositors' interests.

4.17 Taking an overall view of the matter in the context of the present circumstances, the Group is not in favour of prescribing any ceiling on the rates of interest offered by non-banking non-financial companies on deposits received from the public.

NORMS TO BE PRESCRIBED IN RESPECT OF CAPITAL REQUIREMENTS, BORROWINGS, ETC.

4.18 The requirements of non-financial companies by way of capital, borrowings, etc., would vary from industry to industry depending on the nature of the industry and other relevant factors. Moreover, the terms of reference of the Study Group set up by the Reserve Bank under the chairmanship of Shri P. L. Tandon for examining the various aspects relating to follow-up and supervision by banks of the credit extended by them, *inter alia,* require the Group "to suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings" and also "to make recommendations regarding the sources for financing the minimum working capital requirements". We do not, therefore, propose to deal with these aspects so far as the non-financial companies are concerned; our recommendations in regard to financial companies are given in Chapter 5.

ASSESSMENT OF CREDIT REQUIREMENTS OF NON-FINANCIAL COMPANIES BY BANKS

4.19 The present practice in regard to banks taking into account the quantum of finance raised by companies by way of deposits while assessing their overall credit requirements is not uniform. Some bankers contended before us that they did take into account the quantum of deposits at the time of sanctioning the credit limits. Others gave us to understand that it was neither feasible nor practicable to do this because there was nothing to prevent a company from raising deposits after the credit limits had been sanctioned by the bank. We are unable to appreciate the force of the latter argument. In our view, a lending bank should invariably take into account the quantum of deposits received by the borrowing company while sanctioning/renewing credit facilities to it and also stipulate that the borrowing company should advise the bank about the quantum of deposits proposed to be raised by it; when such deposits are in fact raised, the lending bank should make necessary adjustments in the credit limits sanctioned to the company. Such a step would go a long way in enforcing financial discipline on the borrowing company, besides being conducive to a better enforcement of the credit policy laid down from time to time by the Reserve Bank.

4.20 Another view which was expressed before us in this connection was that companies may be allowed to accept deposits only up to the limits to be determined and specified by their bankers when they work out periodically

the overall financial requirements of the companies. We are unable to accept this suggestion as it would be tantamount to vesting the commercial banks with the indirect authority to regulate the deposit-acceptance activities of non-financial companies. Further, acceptance of this suggestion may create an impression that the bank concerned vouchsafes the financial soundness of the company and its ability to repay the deposits on maturity.

MAINTENANCE OF LIQUID ASSETS

4.21 In our view, liquidity of at least a portion of a company's funds for meeting the liabilities to depositors as and when the deposits mature for repayment is one of the important factors which a company has to take into account; for this purpose, the borrowing company should plan its deposit-acceptance in such a manner that the maturity pattern of deposits does not cast an undue pressure on it at any point of time. While some of the representative organisations agreed that due provision should be made by companies to meet their maturing liabilities in respect of deposits, there were varying opinions as to the manner in which this could be done. One view was that companies accepting deposits may be required to maintain at all times a margin equivalent to 5 per cent of the total deposit liabilities in the drawing limits available to them from their bankers. Another view was that funds equivalent to at least 5 per cent of its total deposit liabilities should be readily available with a company in the form of liquid assets to meet any emergent situation that may arise. On due consideration of the matter, we recommend that non-financial companies should be required to maintain in current accounts or in other deposit accounts with scheduled banks free from any charge or lien or in unencumbered securities of the Central or of State Governments and not earmarked for any specific purpose or in other unencumbered securities in which a trustee is authorised to invest trust money (such securities being valued at their market value for the time being) or partly in such accounts or partly in such securities, a sum which shall not be less than 10 per cent of their deposit liabilities maturing during the course of the year. In making the above recommendation, we have deliberately omitted "cash in hand" since unlike in the case of banks, large cash balance in hand may not be necessary for non-financial companies.

LEGISLATIVE MEASURES

4.22 As stated in the preceding chapter, an element of dichotomy has been introduced in the matter of regulation of deposit-acceptance activities of NBCs with the coming into operation of the Companies (Acceptance of Deposits) Rules, 1975, made under section 58A read with section 642 of the Companies Act, 1956, with effect from February 3, 1975.

4.23 We have examined the aforesaid Rules, since the terms of reference

of the Group require it to examine the provisions of the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 in the same manner as the directions issued to financial and miscellaneous non-banking companies vis-a-vis the terms of reference. Moreover, section 58A of the Companies Act, 1956 contemplates the making of rules for the purpose of that section in consultation with the Reserve Bank. The Group, therefore, felt that its recommendations relating to the various aspects of regulation of deposit-acceptance by non-financial companies under the Rules would be useful to the Bank in discharging its advisory role and also in the formulation of monetary and credit policy.

4.24 The provisions in the Rules broadly follow the pattern of the directions contained in the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 which have since been withdrawn by the Reserve Bank. The main points of difference have been set out in Appendix VII. The more important aspects of some of the provisions in the Rules have been examined in the following paragraphs.

EXEMPTION OF DEPOSITS RECEIVED FROM SHAREHOLDERS OF PRIVATE COMPANIES AND DIRECTORS OF ALL COMPANIES

4.25 Any money received by a non-financial company from a person who, at the time of receipt of the money was or is a director of the company, or any money received before April 3, 1970 from persons, who, at the time of the receipt of the money were managing agents or secretaries and treasurers of the company or any money received by a private company from its shareholders was exempt from the term "deposit" as defined in the relative directions issued by the Reserve Bank. [vide paragraph 2(1)(f)(vii)]. However, such moneys are not so exempt under the Rules. Moreover, while clause (i) of sub-rule (2) of Rule 3 stipulates a ceiling restriction of 15 per cent of the aggregate of the paid-up share capital and free reserves in respect of certain types of deposits which include, *inter alia,* deposits from the shareholders of the company other than a private company, the use of the words "any other deposit" in clause (ii) of the said sub-rule, in the absence of the exemption clause, would mean that deposits of directors as also those of shareholders of a private company would be subject to a ceiling restriction of 25 per cent of the net owned funds. In our view, deposits received from directors of all companies as well as from the shareholders of a private company should continue to be exempted as under the Reserve Bank's directions so that there are no restrictions on these persons bringing in their own funds thereby increasing their stake in the business of the company; in the case of deposits received from such persons, the question of safety of the deposits from the point of view of the public interest does not also arise.

DEPOSITS RECEIVED FROM SHAREHOLDERS OF PRIVATE COMPANIES DEEMED TO BE PUBLIC UNDER SECTION 43-A OF THE COMPANIES ACT, 1956

4.26 Pursuant to the provisions contained in section 43-A of the Companies Act, 1956, as amended by the Companies (Amendment) Act, 1974, which came into force with effect from February 1, 1975, a private company, irrespective of its paid-up share capital, becomes a public company, if such company has an average annual turnover of not less than rupees one crore over a period of three consecutive financial years or where not less than 25 per cent of the paid-up share capital of a public company, having share capital, is held by a private company. In view of these provisions, the concession available to private companies under the rules in respect of acceptance of deposits from the shareholders without any ceiling restrictions, would be denied to such of the private companies as are deemed to be public by virtue of the aforesaid section 43-A. Private companies are units, whose shares are usually held by persons within a limited periphery, either related to or otherwise known to the promoters or directors of the companies concerned. As such, there is no reason why private companies should not be allowed to accept deposits without any limit from their shareholders, especially when the shareholders keeping deposits have to make a declaration under the Rules that the amounts are not being deposited out of the funds secured by them by borrowing or accepting deposits from any other person. In any event, the number of shareholders in the case of private companies cannot exceed fifty and if it does, the companies concerned cease to be private companies and the applicability of the said section would not arise. Moreover, the question of safety of deposits from the point of view of public interest would not, by and large, arise in such cases. Section 43-A *ibid* is in fact a "deeming" provision and the nature of relationship between a company and its shareholders will not, *ipso facto,* change by virtue of the operation of the section. We, therefore, recommend that the deposits of shareholders of private companies deemed to be public companies by virtue of section 43-A of the Companies Act, 1956 should be given the same treatment as those of shareholders of other private companies, as recommended in the previous paragraph.

EXEMPTION IN CASES OF HARDSHIP

4.27 Clause (ii) of sub-section (7) of section 58A of the Companies Act, 1956 provides that nothing contained in that section shall apply to such other company as the Central Government may, after consultation with the Reserve Bank, specify in this behalf. This provision does not appear to empower Government to grant limited exemption in favour of a non-financial company when the need for such exemption arises. Neither is there any other provision in the Act nor in the Rules, on the lines of paragraph 14 of the Non-Banking

Non-Financial Companies (Reserve Bank) Directions, 1966, under which the Government could, for avoiding hardship or for any other just and sufficient reason, grant extension of time to comply with, or exempt any company or class of companies from, all or any of the provisions of the Rules either generally or for any specified period and subject to such conditions as the Government may impose. We feel that Government may, by suitably amending the Act, assume powers in this behalf, since unqualified compliance with the provisions of the rules may not be possible for all companies at all times.

INTER-COMPANY DEPOSITS

4.28 In terms of sub-clause (iv) of clause (b) of Rule 2, the term 'deposit', as defined in the clause, does not include any amount received by a company from any other company. It was contended before us that if inter-company deposits are exempted from the purview of the rules, it would give rise to malpractices, since a company, whose financial position permits acceptance of deposits, might accept deposits and then divert them to another company which may be in need of funds and whose financial position does not permit acceptance of deposits either due to the ceiling limits already having been reached or due to losses having been incurred in its working, thus putting the interests of the depositors of the former company in jeopardy. While there is some force behind this argument, we feel that inter-company deposits may be exempted from the purview of the definition of the term 'deposit' subject to certain conditions. It may be pointed out that when new ventures are started, it is not unusual for financial institutions to stipulate that the promoters should bring in a specified portion of the funds of their own for financing the projects. In such cases, if the capital market is shy and/or the capital raised by the new company is in conformity with the usual norms having regard to the nature of the industry, the promoters, in order to comply with the stipulation of the financial institutions, may advance moneys by way of deposits from their companies which are in a position to lend from their surplus resources to the company which starts new projects. Since inter-company deposits thus have a promotional role to play, it would not be desirable that this exemption should be totally withdrawn. However, the relative provision in the rules may be suitably amended to the effect that the exemption in respect of inter-company deposits would be admissible only where the recipient company is a new company, i.e., a company which has not gone into commercial production, and also does not accept any deposits on its own from the public. In other cases, it may be stipulated that for getting the benefit of exemption the recipient company should obtain the prior approval of the Central Government.

DEALERSHIP DEPOSITS

4.29 Any amount received by a non-financial company by way of security or as an advance from any purchasing agent, selling agent, or other agents

in the course of, or for the purposes of, the business of the company or any advance received against orders for the supply of goods or properties or for the rendering of any service is exempt from the term 'deposit' under sub-clause (vi) of clause (b) of Rule 2. Of late, the propriety of exempting such amounts from the purview of the term 'deposit' has become a subject matter of controversy. A view has been expressed that the provisions of the rules regarding ceiling restrictions, etc., could be circumvented by companies by accepting moneys under the guise of security/dealership deposits.

4.30 The Reserve Bank had recently called for particulars from certain companies holding security/dealership deposits of Rs 10 lakhs and above with a view to examining the matter in depth. From the information furnished by them, it was observed that companies had generally received such deposits to cover, in part, financial risks involved in the due performance and observance of the terms of the agreements entered into with the agents. The amount deposited was either a fixed amount or it varied according to the extent of the purchases made by the dealers. One of the terms of the deposits usually provided that in the case of default in payment, the deposits were liable to be adjusted against overdue bills; on termination of the agency, these deposits were liable to be refunded after making necessary adjustments. The rates of interest allowed on such deposits varied from 3 to 13 per cent per annum. In the case of certain companies, no interest was allowed on these deposits. Some companies had also taken money from various customers/stockists, etc., as advances/trade deposits against orders placed/ goods supplied to augment the funds for working capital. By and large, the deposits appeared to have arisen out of business transactions and no abnormal features were noticed to conclude that deposits, other than 'dealership' deposits, had been included under that head with a view to taking advantage of the exemption.

4.31 In view of the foregoing, we feel that while circumvention of the provision cannot be altogether ruled out, cases of this type will be rare. Further, the aggregate amount accepted by way of dealership deposits by companies is also not sizeable. As against a total amount of deposits of Rs 480.8 crores with non-banking non-financial companies or Rs 691.8 crores with the non-banking corporate sector as on March 31, 1972, the amount raised by companies by way of security/dealership deposits was only Rs 30.05 crores. Ordinarily, the amount of dealership deposits is fixed by the manufacturing companies having regard to the turnover of their products sold through the dealers. Another aspect is that some dealers may not be able to offer bank guarantees for the required amount since banks may not give such guarantees without cash deposits being made with them. Since the dealers keep such deposits on their own, having regard to the profits that they would be able to make by sale of manufactured goods, the question of safeguarding the depositors' interests is not relevant in this case. Hence,

we do not think that there is any justification for doing away with the exemption in respect of security/dealership deposits which are accepted by manufacturing companies as a traditional business practice.

EXEMPTION OF CONVERTIBLE DEBENTURES/BONDS FROM THE PURVIEW OF THE TERM 'DEPOSIT'

4.32 The exempted categories of deposits specified in Rule 2(b) do not include money received by issue of convertible debentures/bonds and such amounts are subject to the ceiling of 15 per cent of the net owned funds of a company, as specified in clause (i) of sub-rule (2) of Rule 3. It may be mentioned in this connection that under the directions issued by the Reserve Bank to the non-banking financial as well as non-financial companies in October 1966, which came into force with effect from January 1, 1967, "any loans raised on terms involving the issue of debentures issued by companies, whether they are secured or not" were outside the purview of the ceiling of 25 per cent of the paid-up capital and free reserves. However, with effect from January 1, 1972, unsecured loans accepted by companies against the guarantees of directors, shareholders' deposits, etc., were brought within the purview of a separate additional ceiling of 25 per cent (since reduced to 15 per cent) of the net owned funds. Simultaneously, with the said amendment, the Reserve Bank withdrew the exemption then available to companies in respect of moneys raised on unsecured debentures issued by them and such moneys were also brought within the purview of the same ceiling. It was felt that the position of an unsecured debenture holder was in no way different from that of any other unsecured creditor/depositor of a company and, therefore, such borrowings through the issue of debentures by a company should also be kept within a reasonable limit as a proportion of its net owned funds.

4.33 In our view, while the bringing of moneys raised by issue of unsecured debentures/bonds within the purview of a separate ceiling as mentioned above was not unjustified, the desirability of exempting moneys raised by such issues from the purview of the term 'deposit' merits consideration particularly in the context of certain recent developments. Such debentures/ bonds with an option to convert the whole or part of the amount into equity at a stated price during the specified period subject to the terms and conditions of the issue stand on a different footing. The main advantages which these instruments offer to the issuing company are:

(a) lower cost of financing since the rate of interest offered on such debentures or bonds is generally lower than that on conventional debentures;

(b) increased flexibility of capital structure; and

(c) broad-basing of the share holdings.

From the point of view of the investor, the investment in convertible debentures/bonds besides ensuring a return on his investment, gives him an option to convert his holdings into equity shares at a later stage. The period is usually so fixed as to give the investor an idea of the company's future prospects after the new/expansion project goes into full production. A person investing in such debentures/bonds invariably looks to the general reputation and creditworthiness of the company, the character of its management and the prospects of its future earnings. It would also be pertinent to note that only companies with a sound financial position and reputation and progressively increasing earning power can resort to this form of borrowing. Convertible bonds, which in fact are a deferred issue of share capital, are attractive because of the inherent strength of the underlying equity of the undertaking. Besides imparting an additional strength to the financial position of the issuing company, they also constitute a convenient mode to financial institutions to participate in the capital structure of companies promoting new ventures. The question of exempting convertible debentures/bonds from the term 'deposit' assumes added significance in the context of the stagnant state of the capital market due to the restrictions on dividend payments and other factors. Another aspect which cannot be lost sight of is that while public deposits are generally utilised by companies for meeting their working capital requirements, borrowings by way of convertible debentures/bonds are utilised mainly for the expansion/diversification of a company's business in the same way as moneys obtained through secured debentures.

4.34 There are also other reasons for treating convertible debentures/bonds on a special footing. In the first place, the management of a company has to place the proposal for their issue before the shareholders in a general meeting and get their approval to the terms and conditions of the issue. The company has, thereafter, to obtain the sanction of the Controller of Capital Issues, if the quantum of the issue is over the limit exempted under the Capital Issues (Exemption) Order, 1969. Under proviso (a) to sub-section (3) of section 81 of the Companies Act, 1956, the company has also to obtain the approval of the Central Government for issue of such debentures/bonds and while determining the terms and conditions of such issues, Government is required to have due regard to the financial position of the company, the terms of issue, the rate of interest payable thereon, the capital of the company, its loan liabilities, its reserves, its profits during the preceding five years and the current market price of its shares, as per the provisions of sub-section (5) of that section. Moreover, the inherent strength or marketability of such issues is generally indicated in the willingness of financial institutions or brokers to underwrite them. For these reasons and also in view of the fact that this type of financing strengthens the financial position/equity base of an undertaking, we recommend that convertible debentures/bonds may be exempted

from the term 'deposit' under the Companies (Acceptance of Deposits) Rules, 1975.

CEILINGS ON DEPOSITS

4.35. We may now examine the question whether it would be in order to prescribe the ceiling in respect of the deposits which may be held by a company, as a proportion of its paid-up capital and free reserves (less the balance of accumulated loss, deferred revenue expenditure and other intangible assets, if any) as contemplated under Rule 3(2) of the Companies (Acceptance of Deposits) Rules, 1975 or whether any other norm in this regard would be more appropriate. In this connection, it was urged before the Group that the linking of the quantum of deposits to the net owned funds of a company is not a very useful criterion from the point of view of depositors' interests. According to this view, the safety of deposits depends not so much on the quantum of deposits that a company can accept as on good management and prudent employment of the available resources. Thus, even in a case where the company is operating with a relatively small amount of public deposits, the interests of the depositors may be jeopardised if it is not properly managed. On the other hand, it is equally possible that a company, despite a high component of public deposits, would be in a position to meet its commitments if its funds are employed prudently. Hence, it was suggested that the extent to which a company might be permitted to accept deposits should not be related to its net worth but to a norm indicative of sound financial management, such as availability of assets which would be realised to meet the obligations as they mature. While, from a theoretical point of view, there is some force in the argument put forward in support of a criterion for regulating the quantum of deposits based on the ratio of current assets to current liabilities as a substitute for the existing norm linked with the net owned funds, it will not be practicable to relate the ceiling on deposits to a fluctuating and variable base. It was also argued that a company which had borrowed moneys by way of public deposits according to the ceilings prescribed under the rules may find at a subsequent stage that due to adverse working results, the quantum of deposits accepted by it had exceeded the prescribed ceiling and it would be required to bring down its deposits in a situation where it would be actually in need of further deposits. However, the remedy in such a situation would be not to encourage the company to raise deposits from the public but to nurse the company by providing long-term and working capital finance with the assistance of banks, term-lending institutions and other expert bodies, which would also be in a position to impose the necessary financial discipline and bring about desirable management changes. We feel that all norms other than that of net worth are of a fluctuating nature and even the classification of some of the items which may be taken into account for the purpose of deciding the nature of the

assets or the liabilities might turn out to be controversial. On the contrary, the present norm of fixing the quantum of deposits in relation to a company's net owned funds is, by and large, steady in the course of the accounting year of a company and also administratively feasible. We are, therefore, of the view that the present criterion of relating the quantum of deposits to the net owned funds of a company is by far the most dependable in the circumstances.

4.36 We now turn to consider whether the ceiling limits presently in force are adequate or whether they require any modification. As pointed out earlier, under the directions operative from January 1, 1967, companies could accept deposits to the extent of 25 per cent of the paid-up capital and free reserves—subsequently clarified as 25 per cent of the paid-up capital and free reserves, as diminished by balance of accumulated loss, if any. However, deposits in the form of unsecured loans guaranteed by directors, deposits from shareholders, etc. were exempt from the purview of the directions. With effect from January 1, 1972, the latter category of unsecured loans/deposits was also brought within the purview of the term 'deposit' and a separate ceiling of 25 per cent in respect thereof was prescribed when it was observed that there was a marked shift from conventional fixed deposits to the category of unsecured loans/deposits of the type referred to above, thus, indicating that the companies were abusing the exemption which was then available in respect of the latter category of deposits. We understand that the original intention was to bring this category of unsecured loans/deposits within the then existing ceiling of 25 per cent of the net owned funds in respect of the category of conventional fixed deposits; however, a separate ceiling of 25 per cent was prescribed because it would have otherwise caused undue hardship to companies which had already accepted sizeable amounts by way of unsecured loans guaranteed by directors, shareholders' deposits, etc. Under the directions as amended, companies holding deposits in this category in excess of 25 per cent were required to wipe off the excess as on the date of coming into operation of the amendment in a phased manner by April 1, 1975. This ceiling was reduced to 15 per cent with effect from January 27, 1975 and non-banking non-financial and financial companies having deposits of this category in excess of 15 per cent of their net owned funds were required to liquidate the excess by December 31, 1975. Companies conducting prize chits/lucky draws/savings schemes as also those conducting conventional type of chits which are governed by the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 and which have been allowed time upto the end of September 1976 to wipe off any excess of the guaranteed loans, shareholders' deposits, etc., over the then existing ceiling of 25 per cent are now required to bring down their outstandings in respect of such unsecured loans within the reduced ceiling of 15 per cent by December 31, 1976.

4.37 Notwithstanding the recent reduction of the ceiling in respect of unsecured loans guaranteed by directors, etc., to 15 per cent of the net owned funds of a company with effect from January 27, 1975, we feel that even this reduced ceiling is somewhat on the liberal side. So far as non-financial companies are concerned, we are of the view that in the context of the effective implementation of the monetary and credit policy as also for reducing the reliance of these companies on this form of borrowing which unlike other forms of borrowings, is not subject to any financial discipline, the ceilings available to such companies should be reduced further. With this end in view, we recommend that the ceiling of 15 per cent in respect of unsecured loans guaranteed by directors, shareholders' deposits, etc., may be reduced by another 5 per cent with effect from January 1, 1977 and the balance of 10 per cent may also be completely withdrawn with effect from January 1, 1978. Thereafter, non-financial companies may be allowed to borrow all types of deposits (whether by way of conventional deposits or unsecured loans guaranteed by directors, shareholders' deposits, etc., contemplated under the existing two ceilings) within the overall ceiling of 25 per cent of their net owned funds. Companies holding unsecured loans guaranteed by directors, shareholders' deposits, etc., in excess of the limit consequent on the reduction of the ceiling, may be given one year's time from the date of coming into operation of the respective amendments for regularising the position. We expect that the total withdrawal of the ceiling in respect of unsecured loans, etc., with effect from January 1, 1978 would allow sufficient time to the companies to adjust their financial needs by widening their capital base and/or finding alternative sources of finance for meeting their requirements.

SECURED DEPOSITS

4.38 In terms of Explanation 1 to Rule 3, 'deposit' for the purpose of that rule shall not include any loan secured by the creation of a mortgage, charge or pledge of any of the assets of a company or part thereof, if the amount of such loan does not exceed 25 per cent of the market value of the assets which constitute the security for the loan. Such secured loans do not, therefore, come within the purview of the ceiling restrictions. It would, however, be relevant to consider whether it is at all desirable to create this category of 'secured' deposits so as to take them out of the purview of the ceiling restrictions prescribed under the rules. It may be noted that, prior to the amendment of the directions issued to non-financial and financial companies in August 1973, moneys raised by such companies, on terms involving mortgage, pledge, charge or lien on the assets were exempted from the term 'deposit'. It was observed that companies were soliciting deposits through advertisements without giving the particulars of their financial position, management, etc., on the pretext that such deposits were exempt from the purview of the directions. With a view to removing

this lacuna, the directions were suitably amended effective from September 1, 1973, whereunder loans and deposits received from the public would be exempt only from the ceiling restrictions provided they are secured in the manner referred to earlier. Companies accepting such deposits would, however, be required to comply with the other provisions of the directions relating to advertisements, returns, etc.

4.39 We are, however, of the view that the special treatment given to 'secured' deposits is fraught with dangerous consequences and the exemption granted to such deposits from the ceiling restrictions should be withdrawn for the following reasons:

(a) The fixed and other assets of a company are ordinarily charged by it to banks or other financial institutions for obtaining credit facilities from them and the creation of a further charge on such assets on the basis of their market value is not desirable from the point of view of the depositors' interests. If the security charged were to be enforced by a distress sale or otherwise, the sale proceeds may not be sufficient to satisfy the claims of the lending bank or financial institution having the first charge and also of the depositors. Thus, the security for the deposits would ultimately turn out to be illusory.

(b) If companies are allowed to borrow by way of deposits by securing them against their assets, it would be tantamount to allowing a further ceiling limit to the companies besides the ceiling already available in respect of deposits/unsecured loans under the Companies (Acceptance of Deposits) Rules, 1975.

(c) The margin which may be available in respect of the assets charged to the lending bank/financial institution offers a cushion from the view-point of the safety of the depositors' funds. If, however, such assets are also charged to another category of depositors, the unsecured depositors will be left with virtually no security whatsoever in case the company faces a financial crisis or goes into liquidation.

4.40 In view of the foregoing, we recommend total withdrawal of the facility available to companies of receiving 'secured' deposits by suitably amending the relative provisions. Companies which have already raised deposits in this manner may be allowed a period of three years from the date of the coming into operation of the amendment for repayment of such deposits or for regularising the position in any other manner.

ADVERTISEMENTS

4.41 Sub-rule (2) of Rule 4 which specifies the particulars to be mentioned in the advertisements, requires a company to furnish, *inter alia,* information

about its profits before and after making provision for tax for the three financial years *immediately preceding* the date of the advertisement. Sub-rule (3) of Rule 4 prescribes that an advertisement issued shall be valid only up to the end of the financial year in which it is issued and a fresh advertisement shall be made in each succeeding financial year for acceptance of deposits during that financial year. It appears to us that the aforesaid provisions would create certain practical difficulties to companies. For example, if a company's financial year ends on March 31, then any advertisement issued in that year will expire on that date and a fresh advertisement would be necessary on or after April 1, for the succeeding year. If the company desires to give an advertisement say, on April 1, or soon thereafter, it would be impossible for it to indicate the profits of the company for the three financial years *immediately preceding* the date of the adverintisement as also the dividends declared in respect of the said years [*vide* clauses (f) and (g) of sub-rule (2) of Rule 4] since the requisite particulars in this regard would be available only after some time when the audit of the accounts is completed. We, therefore, recommend that the above provisions may be suitably amended to allow a company to give the figures of profits for the preceding three years in respect of which shareholders have passed the audited accounts. The period of validity of advertisement may also be made to expire not at the end of the financial year but six months after the close of that year or such extended time as may be allowed by the Registrar of Companies for holding the annual general meeting in terms of the second proviso to section 166(1) of the Companies Act, 1956.

4.42 Incidentally, it may be pointed out that under sub-rule (1) of Rule 4, it is obligatory on every company intending to accept deposits from the public other than from its directors, to issue an advertisement in a leading English newspaper and in a vernacular newspaper circulating in the State in which the registered office of the company is situate. Since a number of companies restrict acceptance of deposits to their directors, shareholders and employees, we feel that the compulsory issue of advertisements in the case of these companies might cast an undue financial burden on them. We, therefore, recommend that the issue of advertisements by companies accepting deposits only from their shareholders and employees besides directors may not be made obligatory. However, such companies may be required to file with the Registrar of Companies concerned a statement, in lieu of an advertisement, containing particulars which would have been included in the advertisement; they may also be required to furnish the requisite particulars in the application forms for acceptance or renewal of such deposits.

4.43 The main intention in requiring companies soliciting deposits from the public to furnish certain particulars in their advertisements as also in the application forms for acceptance or renewal of deposits is to enable the prospective depositors to have a fair knowledge/assessment of the business of the company, the character of its management and its financial

position. While the particulars required to be given pursuant to sub-rule (2) of Rule 4 are fairly comprehensive, we feel that a company should be required to give some more particulars in the advertisements and application forms so that prospective depositors could have a clearer picture of its state of affairs over a period as also the legal implications arising out of keeping deposits with it. These are—

(a) a summarised balance sheet position of the company for the three preceding accounting years [This may be prescribed in lieu of the particulars mentioned in items (i) to (v) of clause (h) of sub-rule (2) of Rule 4, item (vi) of the clause being given as clause (i) in sub-rule (2)];

(b) amount of deposits which the company can accept under the ceilings and the amounts actually received as on a recent date;

(c) amount of overdue deposits other than unclaimed deposits; and

(d) a declaration to the effect that—

(i) the company has complied with the provisions of the Companies (Acceptance of Deposits) Rules, 1975;

(ii) compliance with the said Rules does not imply that the repayment of the deposits is guaranteed by the Central Government; and

(iii) the deposits accepted by the company are unsecured ranking *pari passu* with other unsecured liabilities.

It was observed that the advertisements given by some companies/their brokers pursuant to the Reserve Bank's directions contained legends such as "As per Reserve Bank Directions", "Complied with the Reserve Bank's Directives", etc., giving an impression to unwary depositors that the companies were accepting deposits with the prior approval of the Reserve Bank. In order to forestall a similar impression being given by non-financial companies/their brokers while advertising pursuant to the aforesaid Rules, a provision as in item (d)(ii) above has been suggested.

PROVISIONS RELATING TO PREMATURE REPAYMENT OF DEPOSITS

4.44 In terms of sub-rule (1) of Rule 8, where a company makes repayment of a deposit after the expiry of a period of six months from the date of such deposit but before the expiry of the period for which such deposit was accepted by the company, the rate of interest payable by the company on such deposit shall be reduced by one per cent from the contracted rate

and the company shall not pay interest at any rate higher than the rate as so reduced. With a view to ensuring that the provisions relating to the premature repayment of deposits are generally in line with the directives issued by the Reserve Bank to scheduled commercial banks (vide circular DBOD No. Sch. BC. 66/C.347-74 dated July 22, 1974 as modified by DBOD. No. Dir. BC. 4/C.347-75 dated January 14, 1975*), we suggest that where a company makes a repayment of a deposit after the expiry of six months from the date of deposit but before the expiry of the period of deposit agreed upon at the time of deposit, the rate of interest payable on such deposit shall be 2 per cent lower than the relative rate for the period nearer to the completed year for which the deposit has run or is about to run. For example, if a three-year deposit is prematurely repaid at the end of 14 months, the rate of interest payable will be the rate applicable for one-year deposit less 2 per cent; if such deposit is repaid at the end of 18 months, the rate of interest payable will be as for a two-year deposit less 2 per cent. We also recommend that a provision may be made in the sub-rule that this compulsory reduction by 2 per cent will not be applicable in the case of a deposit which is repaid before maturity in order to comply with the Companies (Acceptance of Deposits) Rules, 1975.

4.45 Sub-rule (2) of Rule 8 provides that in respect of any deposit which is repaid within periods ranging between fourteen days and six months from the date of receipt, there shall be paid interest not exceeding the rates specified in the said sub-rule. The proviso to the rule also states that nothing in that rule shall apply to a deposit, the terms and conditions of which provide for earlier repayment of the deposit at the option of the company and the deposit is repaid earlier in pursuance of such option. We are not able to appreciate the significance of the provisions just referred. The underlying intention of sub-rule (1) *ibid* referred to earlier is to ensure that non-banking non-financial companies do not accept deposits for a period less than six months (except to a limited extent—see paragraph 4.11). However, the effect of sub-rule (2) of Rule 8 would be to allow companies to accept deposits for a specified period and then repay such deposits after the expiry of a shorter period thus converting time deposits into short-term/ demand deposits, the acceptance of which is a legitimate function of banks. We, therefore, recommend that sub-rule (2) of Rule 8 as also the proviso to that rule be deleted.

RETURN OF DEPOSITS TO BE FILED WITH THE REGISTRAR

4.46 In terms of Rule 10, every company to which the rules apply shall, in each year, file with the Registrar of Companies within thirty days from

* See pp. 1265-68 of Reserve Bank of India Bulletin, July 1974 and pp. 32-33 of Reserve Bank of India Bulletin, January 1975.

the last day of its financial year, a return containing certain particulars specified therein. Since the financial years of companies differ, there will be no uniformity in the date with reference to which the position of all companies in regard to the deposit-acceptance activities could be watched, especially in respect of compliance with the requirements of the provisions relating to ceilings on deposits. It would not also be possible in such circumstances to make a comprehensive study of the quantum of deposits held by non-financial companies at any given point of time. We, therefore, recommend that the particulars mentioned in Rule 10 may be standardised in a prescribed form on the lines of the return in Form D which had been prescribed under the Reserve Bank directions issued to non-banking non-financial companies; the particulars to be furnished by a company in the said return should be duly certified by its statutory auditors and may relate to a specified date, viz., March 31, of each year, which was also the date specified in the Reserve Bank directions. Further, the feasibility of amending Part I of Schedule VI to the Companies Act 1956 requiring companies to disclose the regulated deposits as a separate item on the liabilities side of the balance sheet may be examined. This would cast an obligation on the statutory auditors to verify compliance by companies with the ceilings on deposits prescribed under the rules. With a view to enabling a qualitative study of the deposits held in the non-banking corporate sector, non-financial companies may also be required to send simultaneously a copy of the return to the Reserve Bank by June 30, as had been provided in its directions. This would facilitate carrying out of surveys of deposits held by companies in the non-banking corporate sector.

CHAPTER 5

NON-BANKING FINANCIAL COMPANIES

INTRODUCTION

5.1 NBFCs incorporated under the Companies Act, 1956 belong to the species of what are commonly known as NBFIs. In a very broad sense, NBFIs would include even financial institutions like insurance companies, Life Insurance Corporation of India, Unit Trust of India, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India Ltd., Industrial Finance Corporation of India and Industrial Reconstruction Corporation of India Ltd., as also State Financial Corporations. But for the purpose of our present study, the scope of the term is confined to the types of financial companies enumerated in clause (p) of paragraph 2(1) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, which mobilise savings of the community by way of deposits or otherwise and utilise them for the purpose of lending or investment. Thus the NBFCs that we shall discuss in this chapter are hire-purchase finance, housing finance, investment, loan, miscellaneous financial or mutual benefit financial companies but excluding insurance, stock exchange or stock-broking companies.

MAGNITUDE OF DEPOSITS WITH NBFCs

5.2 The amount of deposits with NBFCs as at the end of March 1972 (the latest date for which data are available) was Rs 211 crores and constituted about one-third of total deposits of NBCs (Table 5.1).

Among the NBFCs, two types of companies, viz., loan companies and hire-purchase finance companies accounted for about 65 per cent of the total deposits of NBFCs, the proportion of deposits with the former to the total being 40 per cent and that with the latter 25 per cent. Although figures after March 1972 are not available, it is fairly certain that the number of NBFCs and the deposits with them, particularly with loan companies and hire-purchase finance companies, have continued to grow. While the magnitude of deposits with NBFCs as compared to the deposits of commercial banks may appear to be small, considering the absolute amount and the large number of depositors involved as well as the incidence of malpractices in these companies, effective regulation of their activities merits careful consideration.

DISTINCTION BETWEEN BANKS AND NBFIs

5.3 The distinction between banks and NBFIs is mainly in the nature of

TABLE 5.1—GROWTH OF DEPOSITS OF FINANCIAL COMPANIES DURING 1970-1972

(Amounts in crores of Rupees)

Type of company	March 31, 1970		March 31, 1971		March 31, 1972	
	No. of companies reporting deposits*	Total of deposits and exempted loans	No. of companies reporting deposits*	Total of deposits and exempted loans	No. of companies reporting deposits*	Total of deposits and exempted loans
1. Hire-purchase Finance Companies	112 (16.6)	17.5 (14.7)	137 (17.8)	22.7 (15.2)	140 (15.2)	51.5 (24.4)
2. Loan Companies	165 (24.4)	67.1 (56.4)	179 (23.4)	86.2 (57.6)	216 (23.5)	84.6 (40.1)
3. Investment Companies	179 (26.5)	14.2 (12.0)	205 (26.7)	16.0 (10.7)	228 (24.7)	17.3 (8.2)
4. Housing Finance Companies	1 (0.1)	0.5 (0.4)	1 (0.1)	0.5 (0.3)	3 (0.3)	0.6 (0.3)
5. Mutual Benefit Financial Companies	64 (9.5)	13.6 (11.4)	63 (8.2)	15.0 (10.0)	65 (7.1)	15.8 (7.5)
6. Chit Fund Companies	100 (14.8)	1.9 (1.6)	117 (15.2)	2.7 (1.8)	189 (20.5)	3.6 (1.7)
7. Miscellaneous Financial Companies	55 (8.1)	4.2 (3.5)	66 (8.6)	6.6 (4.4)	80 (8.7)	37.6 (17.8)
8. Total	676	119.0	768	149.7	921	211.0

Notes: 1. Figures in brackets indicate percentages to the corresponding totals.
2. Loans obtained from foreign sources though treated as deposits up to the end of the year 1971, have been excluded to facilitate comparison of data.
* Includes companies which have submitted returns but do not hold deposits/exempted loans or other receipts.
Source: Reserve Bank of India Bulletin—September 1973 (pp 1443) and April 1975 (pp 235-246).

the liabilities of the two and, to some extent, in the structure of their assets. While the liabilities of commercial banks usually consist of demand and time deposits, those of NBFIs do not ordinarily include demand deposits, the mutual benefit financial companies, commonly known as nidhis, being notable exceptions. Since demand deposits which are withdrawable by cheque are considered to be a component of 'money', it is the degree

of 'moneyness' of the liabilities of the two types of institutions which constitutes a major difference between the two. From the point of view of assets held, it may be said that commercial banks hold a wide variety ranging from short-term and medium-term to long-term credits and they also use various credit instruments like overdrafts, cash credits, bills, etc. On the other hand, the assets of NBFIs are more specialised. For instance, hire-purchase finance companies confine their operations mainly to the financing of transport operators and consumer credit while housing finance companies make loans for housing purpose. It may, however, be stated that the difference in the nature of assets held by commercial banks on the one hand and those held by NBFIs on the other does not clearly demarcate the respective fields of the two because commercial banks are also, of late, making advances in fields like transport and consumer credit, which were earlier considered as out of their purview*.

ROLE OF NBFIs

5.4 NBFIs like banks and other financial institutions act as intermediaries between the ultimate savers and the ultimate borrowers. The rationale of their existence derives from the fact that in an economy there are surplus units which save and deficit units which are in need of such savings and a mechanism is needed to bring the two together. Surplus units (savers) can lend to the deficit units (borrowers) directly. This, however, is normally inconvenient to both the savers and borrowers and is certainly not the most efficient means of flow of funds between the units. With the mediation of financial institutions, there is a reduction in the degree of risks involved and there is also a more efficient utilisation of the resources in the economy. Financial intermediaries can provide a more economical service because of the economies of scale, their professional expertise and their ability to spread the risk over a large number of units. Thus, their operations give to the saver the combined benefits of higher return, lower risk and liquidity. The borrowers on the other hand also get a wider choice on account of intermediation of financial institutions. It may be of relevance to note that while the loans granted by commercial banks are, by and large, for industrial, commercial and agricultural purposes, those granted by NBFIs are generally for transport, trading, acquisition of durable consumer goods, purchase and repair of houses or just for plain consumption. Since their activities are not controlled by monetary authorities to the same extent as those of commercial banks, the credit extended by NBFIs may not necessarily be in consonance with national objectives and priorities.

5.5 As stated earlier, the major function of financial intermediaries is to transfer the savings of surplus units to deficit units; hence, they can play a

* See the Report of the Study Group on Non-Banking Financial Intermediaries, Banking Commission (Government of India), 1971—paragraphs 2.2 and 2.3.

useful role in the economy of the country. To the extent that they help in monetising the economy and transferring unproductive financial assets into productive assets, they contribute to the country's economic development. In fact, the nature and diversity of financial institutions themselves have become measures of economic development of a country.

APPROACH TO THE PROBLEM

5.6 Most of NBFCs are institutions whose functioning in the mobilisation of deposits and investment of funds by way of advances or otherwise is akin to banking. The necessity of determining the nature of controls which could be imposed on these companies for the purpose of better enforcement of monetary and credit policy of the country as also for affording a degree of protection to the interests of depositors, has assumed added significance due to the reported progressive deterioration in the management and financial position of certain financial companies and their ultimate failure. On the basis of the information collected by the Group during the course of its discussions with individuals/representatives of organisations at various centres, the study on the finance and chit fund companies in the Delhi area conducted by the Economic Department of the Reserve Bank and the data made available to the Group by the Department of Company Affairs of the Government of India, the failure of such financial companies could be mainly attributed to one or more of the following factors:

(i) non-viability of the companies due to the smallness of their operations;

(ii) inadequate capital base, paucity of liquid funds and heavy reliance on borrowed funds;

(iii) dishonesty and lack of integrity of the promoters and directors in the management of the companies;

(iv) grant of unsecured advances to directors or their relatives or the firms in which they are interested at nominal rates of interest or even without interest though funds might have been borrowed by way of deposits or otherwise at high rates of interest;

(v) extravagant establishment expenses on items such as maintenance of luxurious office premises, publicity, payment of high salaries to some of the members of the staff out of proportion to the turnover or magnitude of the company's business; and

(vi) perpetration of frauds either by misappropriating the moneys received by way of deposits and not accounting them in the books of account or by making advances in the names of fictitious parties.

From the foregoing, it would be evident that if such deficiencies or malpractices in their working are to be minimised, if not eliminated, it would

be necessary to devise stricter types of controls on the deposit-acceptance activities of the companies and to regulate other aspects of their management. Also, the nature of controls should be such that the weaker units could be weeded out, and where necessary, stronger units could be formed by mergers. Further, the regulatory measures should ensure that the functioning of the companies is broadly in tune with the national objectives and priorities and is not detrimental to the interests of the depositors. In short, NBFCs should be subjected, by and large, to the same type of controls as banks under the Banking Regulation Act, 1949.

5.7 In the course of discussions which the Group had in Bangalore with certain individuals (including an association representing depositors), it was represented that the 'Finance Corporations' operating in Bangalore and other places (which, being partnership firms with a capital investment of less than Rs 1 lakh or sole proprietorships, are not presently covered by the regulatory measures of the Reserve Bank) accept deposits from the public out of all proportion to their owned funds and invest the funds in the ventures of the choice of the partners which cover such activities as film production, hotel business, construction and the usual manufacturing and trading activities. A major portion of their funds is reported to have been invested in the construction of imposing buildings. Such buildings which also house the offices of the corporations concerned create a favourable impression in the minds of the gullible public and they are often led to keep deposits with these corporations. On the other hand, the corporations are tempted to borrow to the hilt and lock up the funds by investing them in illiquid and risky assets. If for any reason, the business comes to a standstill, as recently happened in the case of one finance corporation, the depositors become the ultimate losers. It is gathered that the partners in some corporations in practice consider the deposits as their share in proportion to their contribution and use or lend the former in any manner they deem fit. It was, therefore, suggested that regulation of their activities by imposition of a ceiling on borrowing and also the manner of utilisation of funds was necessary.

5.8 As regards bringing the activities of the above types of firms within the ambit of the regulatory measures, it may be mentioned that Government has already taken a decision to prohibit acceptance of deposits by all unincorporated non-banking institutions and legislative measures to give effect to this decision are on the anvil. When the necessary legislation is enacted, the finance corporations will either have to stop acceptance of deposits or convert themselves into corporate bodies.

5.9 Before we proceed to make detailed recommendations on the regulation of NBFCs, it would be useful to point out a special aspect of the problem, viz., links between financial companies and commercial banks.

5.10 In advanced countries like U.K. and U.S.A., existence of a substantial non-banking sector has not caused a major problem to the monetary authorities partly because all non-banking institutions, including financial intermediaries, are dependent upon the commercial banking system or have other links with commercial banks with the result that monetary and credit policy can be effectively enforced through the control of commercial banks and partly because independent legislation for dealing with institutions like building societies, house mortgage corporations, hire-purchase finance companies, trustee savings banks and mutual benefit societies, has been enacted and is being enforced in accordance with the regulations which go into considerable detail. However, except in the case of certain specialised institutions like Unit Trust of India, Industrial Finance Corporation or State Financial Corporations, there is no comprehensive legislation in India to cover the activities of various types of financial intermediaries*.

5.11 As a result of the implementation of our recommendations and enactment of comprehensive legislation@, it may be expected that financial companies would, in due course, emerge as strong and viable units. This process will be facilitated if the activities of financial companies could be linked with those of commercial banks. Such linking could be established by the banks by offering refinance facilities to the financial companies on a selective basis in respect of hire-purchase, housing and/or other fields which fall within the priority or neglected sectors. If these links are established, banks could initially subject the borrowing companies to financial discipline and might even appoint their nominees on the Board of Directors. The dovetailing of the activities of the financial companies with those of banks would not only ensure better safety of the depositors' funds but would also facilitate better direction of the monetary and credit policy by the Reserve Bank enforced through commercial banks.

NATURE OF REGULATION

5.12 In order to decide upon the nature of regulation of NBFCs, it would be desirable to make a distinction between financial companies which are run purely on commercial considerations such as hire-purchase finance, housing finance, investment, loan and miscellaneous financial companies on the one hand and companies which are run for the mutual benefit of their members, viz., companies conducting only conventional type of chits and mutual benefit financial companies (nidhis) notified by the Central Government under section 620A of the Companies Act, 1956. Having regard to the nature of operations and clientele served by the latter category of companies which function purely in the mutual interest of their members, the nature of controls on them need not be the same as in the case of the former category of companies.

* An Act (Hire-Purchase Act, 1972) has been passed by Parliament but has not yet been brought into force.

@ See paragraph 5.56.

5.13 It may be stated in this connection that subscriptions received by companies towards conventional type of chit schemes conducted by them are excluded from the purview of the term 'deposit' in terms of sub-clause (i) of clause (d) of paragraph 3(1) of the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973; as such, only deposits accepted by these companies come within the purview of the above directions. However, we have recommended in the next chapter* that acceptance of deposits by chit fund institutions other than deposits kept with them by subscribers as advance payment of subscriptions or by prized subscribers by way of security for payment of their future instalments, should be prohibited under the proposed legislation regulating chit funds.

5.14 As regards nidhis, any money received by them from their members is excluded from the purview of the term 'deposit' in terms of sub-clause (viii) of clause (f) of paragraph 2(1) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966. In other words, deposits received by such companies from their members are exempt from the restrictions contemplated by the directions such as period of deposits, ceilings on the quantum of deposits, etc. These companies have a restricted clientele and their business is also run generally in a conservative manner. Since the performance of nidhis is, by and large, satisfactory, we recommend that the *status quo* in respect of these companies as obtaining under the present directions may be maintained, Thus, except as otherwise specifically stated, the scope of our recommendations in regard to financial companies will not extend to nidhis.

5.15 In Chapter 4, we have analysed the conflicting viewpoints in regard to the deposit-acceptance activities of non-financial companies presented before us in the course of the discussions with certain individuals, representatives of Chambers of Commerce and Industry, etc., and also in the written memoranda submitted to us. Much of the evidence tendered before us related to acceptance of deposits by non-financial companies whose vigorous drive for deposit mobilisation has attracted considerable public attention. Our observations and conclusions on the need for effective regulation of acceptance of deposits by non-financial companies apply with suitable changes to similar activities of financial companies; hence only the broad distinguishing features and further elucidations where required, as also our recommendations in regard to financial companies have been given in the succeeding paragraphs.

SAFETY OF DEPOSITORS' FUNDS

5.16 Unlike in the case of deposits accepted by non-financial companies, which are used generally for their own business, borrowed funds constitute

* See paragraph 6.18(d).

the 'raw material' of financial companies. Since these funds are utilised by financial companies for the purpose of lending or investment, it becomes imperative that the lending aspects of these companies are also regulated with a view to ensuring the safety of depositors' funds to the extent possible. Further, in view of the risks involved in regard to the advances made by financial companies, the question whether their deposits should be covered by deposit insurance scheme assumes added significance. It may, however, be pertinent to note that insurance cover was extended to bank deposits after a lapse of nearly twelve years of the bringing into force of the Banking Regulation Act, 1949. As a result of the enforcement of the provisions of the Act, the methods of operation of commercial banks were considerably toned up and standardised; the process of weeding out weaker units by amalgamation of units was also set in motion, which led to consolidation of the banking system in the country. It would, therefore, be obvious that bank deposits were covered under deposit insurance scheme only after the rationalisation and consolidation of the banking system had been achieved to a large extent. Further, the working of commercial banks is under the close surveillance of the Reserve Bank through inspections, obtention of the various statutory returns, prior approval in regard to appointment of Chief Executive Officer, and nomination of directors or observers on the Boards of Directors of banks.

5.17 In the case of NBFCs, none of these factors is obtaining at present. In the circumstances, before the question of extending insurance cover to financial companies could be considered, it will have to be ensured that their methods of operation are standardised, weaker units are weeded out by amalgamation or otherwise and their working is, by and large, put on sound footing. This can be achieved only over a period of time by keeping a strict watch over the activities of financial companies through inspections, etc. In any event, if deposit insurance cover were to be extended to deposits of non-banking financial companies, it would obviously result in a large scale diversion of deposits from the banking to the non-banking sector, in view of the neutralisation of the risks involved and the better return by way of interest on deposits with financial companies. This is not a desirable prospect in the present context since credit extended by NBFCs does not necessarily conform to accepted social objectives. In the circumstances, extension of insurance cover to deposits with financial companies is neither feasible nor desirable for the present but can be a long-term objective.

PERIOD OF DEPOSITS

5.18 The minimum period for acceptance of deposits by financial companies may remain at six months as at present for the reasons given in paragraph 4.10. As regards the maximum period, we are of the view that it should be fixed at three years as recommended in paragraph 4.12, in the

case of hire-purchase finance, investment, loan and miscellaneous financial companies. As regards housing finance companies, it may be pointed out that their investments are generally in long-term assets such as mortgages of house properties. Therefore, the maximum period of deposits in the case of housing finance companies which are exclusively doing the business of financing the acquisition or construction of houses, including acquisition or development of plots of land in connection therewith, may be five years. In the case of nidhis which accept deposits only from their members, we have already pointed out in paragraphs 5.12 and 5.14 that since they are mutual benefit institutions and their working has been found, by and large, to be satisfactory, we have recommended that the *status quo* in respect of these companies as obtaining under the present directions may be maintained. Hence, the question of prescription of a maximum period on deposit-acceptance by them does not arise.

RATES OF INTEREST ON DEPOSITS AND ADVANCES

5.19 In paragraphs 4.13 to 4.16 we have explained why we are not in favour of prescribing ceilings on interest rates payable on deposits by non-financial companies. We are of the view that most of the reasons advanced in that context apply with equal force in regard to NBFCs. Considering the fact that credit extended by NBFCs is, in a significant measure to sectors which are low in the scale of social priorities, the prescription of a ceiling on interest rates on advances would not be desirable. In any case, these rates are subject to the ceiling prescribed in most of the States under the relative provisions of the money-lending Acts in force. In the case of hire-purchase finance companies, section 7 of the Hire-Purchase Act, 1972 places a limitation on the hire-purchase charges (which include interest) which the owner may charge. When this Act is brought into force, the interest chargeable by the companies will also be regulated in terms of the above provision. Hence we are of the view that interest rates payable by NBFCs on deposits and also those chargeable on advances need not be regulated at least under the present conditions.

CEILINGS ON DEPOSITS/BORROWINGS BY WAY OF UNSECURED LOANS

5.20 Before we discuss the question of prescribing ceilings on deposits accepted by NBFCs it would be useful to take a look at the experience of commercial banks in this regard. As will be seen from paragraph 12.66 of the Report of the Banking Commission, the ratio of paid-up capital and free reserves to aggregate deposits of 10 per cent was considered ideal in the case of banks in the early stages. But it was modified as 6 per cent subsequently. In other words, commercial banks could accept deposits up to about 17 times their net owned funds. The rapid increase in deposits

in recent years has brought down the ratio of owned funds to deposits to 1.3 per cent as at the end of March 1974 in spite of the fact that banks are required to transfer 20 per cent of their declared profits to reserves every year.

5.21 Owned funds of financial institutions strengthen their financial position and viability by providing a cushion against unforeseen eventualities; they are also a source of funds for fixed assets like buildings. The question is whether the ratio between owned funds and deposits considered ideal or normal for commercial banks should be equally applicable to NBFCs. As has been pointed out earlier, the commercial banking system is at present well integrated whereas the NBFCs vary greatly in their operations. Moreover, the nature of operations of different kinds of NBFCs also calls for a differentiation in the ratio that may be appropriate for determining the ceilings on deposits which they may accept. It would, therefore, be useful to discuss these questions in the context of the activities of various kinds of NBFCs.

5.22 As for hire-purchase finance companies, the present directions issued to financial companies do not lay down any ceilings on the quantum of deposits which they may accept. These companies are, however, required to maintain by way of liquid assets a minimum of 10 per cent of the deposits outstanding in their books on any day. Further, these companies have to ensure that hire-purchase debts are collected within a reasonable period in the manner stipulated in the directions.

5.23 Three major points have to be taken into account in considering the question of prescribing ceilings on deposits accepted by hire-purchase finance companies. First, there is a continuing need for encouraging the operations of well-managed hire-purchase finance companies because they satisfy the credit requirements of transport operators who belong to the priority sector of borrowers. According to the earlier studies as well as the one undertaken for the Group by the Economic Department of the Reserve Bank into the working of hire-purchase and other finance companies in Delhi, many transport operators preferred hire-purchase finance companies to commercial banks on account of the informality of arrangements and the reluctance of commercial banks to extend finance on second-hand vehicles. Secondly, there is a wide variation in the operations of different hire-purchase companies working in the country. While the southern region is relatively well-served by hire-purchase finance companies, other regions, in particular the eastern region, are relatively neglected in this regard. In the north, although the number of hire-purchase finance companies has tended to increase, there are a number of weak units among them. The study referred to above shows clearly that many of the hire-purchase finance companies in Delhi failed because of the dishonesty of management as well

as low stake of the owners in the concerns. This leads us to the third point, viz., the reliance of hire-purchase finance companies on deposits and borrowings. Since their major business is to finance the purchase of vehicles, they have to borrow from the public as well as other financial institutions. Here also, there is a wide variation between different companies. By and large, the majority of well-managed hire-purchase finance companies has been able to work with a total amount of deposits which was less than 5 times their owned resources; in the case of the weak and small companies, the figure came, in most cases, to 10-15 times and in one case to as much as 32 times.

5.24 The above discussion points out the necessity of protecting the depositors' interest by increasing the stake of the owners of hire-purchase finance companies in their business. It has been observed that several of these companies neither maintained the stipulated percentage of liquid assets nor effected recovery of hire-purchase debts in the manner prescribed in the directions. The Hire-Purchase Act, 1972, (which has not been brought into force so far) makes provisions for protecting the interests of the parties to hire-purchase transactions but it does not provide for effective regulation of the different aspects of working of these companies, such as capital requirements and extent of borrowings which would ensure protection of the interests of the depositors.

5.25 In view of the above considerations, we feel that a ceiling should be prescribed on the total amount of deposits of hire-purchase finance companies in relation to their net owned funds, i.e., paid-up capital and free reserves less all intangible assets. At the same time, the ceiling should be such as to leave scope for expansion of business of well-managed existing companies and provide scope for new companies. Taking into account the data relating to individual hire-purchase finance companies, we suggest that deposits of hire-purchase finance companies should not exceed 10 times their net owned funds. While imparting a measure of protection to depositors, the prescription of the ceiling would also mean that weaker units will have to increase their owned funds or merge with stronger units. This will tend to make the hire-purchase finance system stronger.

5.26 Housing finance companies are, like hire-purchase finance companies, presently exempt from the ceiling restrictions on deposits placed on other NBFCs. These companies resort to borrowings by way of deposits or otherwise in order to lend to clients for the purchase or construction of houses and development of plots. Therefore, their assets are generally secured by mortgages of immovable properties. Considering the fact that the value of real estate has been going up, there would be an element of in-built cushion for the depositors' funds. In addition, housing finance companies serve a major priority need of the community because there is

an acute shortage of housing in the country. In view of these considerations, the present exemption in the case of housing finance companies in so far as the ceilings on deposits are concerned, may continue.

5.27 Other types of financial companies comprise loan companies, investment companies, and what are called miscellaneous financial companies, i.e., those carrying on two or more classes of financial business. All these types of companies are at present permitted to borrow up to 25 per cent of their paid-up capital and free reserves as diminished by the balance of accumulated loss, if any, by way of conventional deposits and up to another 15 per cent, as unsecured loans guaranteed by directors, shareholders' deposits, etc. The Group has considered the types of business done by each of the above categories and makes the following recommendations in regard to them.

5.28 As for loan companies, as already pointed out, their operations are analogous to those of banks. In other words, they depend basically on the margins between their deposit and advance rates for their profits and their viability. The Group feels that since these companies are similar to banks, the ratio of net worth to deposits should be 1 : 10 which would give them a reasonable chance of profitable working. The ratio suggested is the same as the one recommended in the case of hire-purchase companies.

5.29 So far as investment companies are concerned, most of them are already working within the ceilings on deposits which are currently in force. While this may be due partly to their observance of law, they do not need deposits in the same manner as loan companies because their assets consist mostly of shares and debentures which can easily be pledged with banks to raise funds as and when required. Besides, it would not be easy for them to meet maturing liabilities of deposits because while their assets could easily be realised, it would mean a loss of income annually produced by these assets. Many of these investment companies are holding companies associated with large industrial houses. For these reasons, we do not consider any special concession to be justified in their case and we, therefore, recommend that the existing ceilings on their deposits should continue for the time being. However, as recommended by us in the case of non-financial companies (see paragraph 4.37), the ceiling of 15 per cent in respect of unsecured loans guaranteed by directors, shareholders' deposits, etc., may be reduced by 5 per cent with effect from January 1, 1977 and the balance of 10 per cent may also be completely withdrawn with effect from January 1, 1978. Thereafter, investment companies may be allowed to borrow all types of deposits (whether by way of conventional deposits or unsecured loans guaranteed by directors, shareholders' deposits, etc., contemplated in the existing two ceilings) within the overall ceiling of 25 per cent of their net owned funds. Companies holding unsecured loans guaranteed by directors, shareholders' deposits, etc., in excess of the limit consequent on the

reduction of the ceiling, may be given one year's time from the date of coming into operation of the respective amendments, for regularising the position. We expect that the total withdrawal of the aforesaid ceiling of 15 per cent with effect from January 1, 1978 will allow sufficient time to investment companies to adjust their financial requirements and that they will be in a position to work within the overall ceiling of 25 per cent without any difficulty after that date.

5.30 With respect to miscellaneous financial companies, since they would be of a mixed type, we would suggest that they be identified as falling in any one or other categories of hire-purchase finance companies, loan companies and investment companies and the ceilings applicable to them should be determined accordingly.

5.31 As regards nidhis, moneys received from their members are excluded from the term 'deposit' as defined in the directions; as such, the ceilings on deposits are not applicable to them. We recommend that the *status quo* may be maintained.

5.32 Our recommendations relating to the ratio between net worth and deposits should be taken in conjunction with those relating to increase in paid-up capital and reserves (see paragraph 5.36). The two taken together will strengthen the financial position of NBFCs.

DEPOSITS RECEIVED FROM SHAREHOLDERS OF PRIVATE COMPANIES DEEMED TO BE PUBLIC COMPANIES UNDER SECTION 43A OF THE COMPANIES ACT, 1956

5.33 In paragraph 4.26, we have explained why private companies deemed to be public companies by virtue of section 43A of the Companies Act, 1956 should not be so deemed in so far as the exemption from ceiling restrictions in respect of the quantum of deposits which private companies can accept from their shareholders is concerned. The same reasons hold good in the case of private financial companies as well. We, therefore, recommend that the deposits of shareholders of private financial companies deemed to be public companies by virtue of the above section should be given the same treatment as those of other private companies. This would, however, be subject to our recommendation in paragraph 5.43 to the effect that if a private company issues any advertisement soliciting deposits, it shall be deemed to be a public company for the purpose of certain sections of the Companies Act, 1956, specified in the said paragraph.

NORMS REGARDING CAPITAL REQUIREMENTS

5.34 As stated earlier, a significant characteristic of several financial companies is their low capital base. A study of the capital structure of 89 com-

panies in the Delhi area revealed the following position of the size of their paid-up capital:

Paid-up capital	No. of companies
Upto Rs. 5,000	7
Between Rs. 5,001 and Rs. 10,000	6
Between Rs. 10,001 and Rs. 25,000	12
Between Rs. 25,001 and Rs. 50,000	12
Between Rs. 50,001 and Rs. 1,00,000	15
Between Rs. 1,00,001 and Rs. 5,00,000	29
Between Rs. 5,00,001 and Rs. 10,00,000	6
Over Rs. 10 lakhs	2
	89

It will be observed from the foregoing that the capital funds of the bulk of these companies were below Rs. 5 lakhs. Further, the free reserves of these companies were either negligible or very low. Some of them also carried forward balances of accumulated loss. The proportion of paid-up capital to total liabilities varied between 5 to 10 per cent in the case of most of these companies. We were given to understand that financial companies are hesitant to raise their capital resources mainly because the promoters or directors of these companies prefer to borrow by way of deposits rather than increase their capital, since it is easier and less costly to service deposits than equity capital. However, as stated earlier, capital resources provide a cushion to the depositors and other creditors besides affording viability to a company and as such the necessity of a sound capital base for companies cannot be under-estimated. Moreover, it is desirable that mushroom growth of financial companies should be discouraged by ensuring that the promoters or directors bring in a reasonable amount by way of capital funds and do not trade mainly on public funds by floating or conducting companies with nominal paid-up capital.

5.35 It may be pointed out that in the case of commercial banks, the criteria of minimum paid-up capital and reserves differ between banking companies which commenced business for the first time after the Banking Companies (Amendment) Act, 1962 came into force* and those which were functioning prior to the date of the commencement of that Act. Section 11(3) of the Banking Regulation Act, 1949 lays down different criteria in regard to the

* This Act came into force on September 16, 1962.

aggregate value (i.e., real or exchangeable value and not the nominal value which may be shown in the books of the banking company) of the paid-up capital and reserves, depending upon whether a bank is a unit bank or a bank having branches in a single State or more than one State, etc. Thus, the aggregate value of the paid-up capital and reserves of a bank if it has only one place of business which is not situated either in Bombay or Calcutta is Rs. 50,000. If it has places of business in more than one State, the minimum required is Rs. 5 lakhs and if such place or places of business is or are situated in the city of Bombay or Calcutta or both, Rs. 10 lakhs; if it has all its places of business in one State none of which is situated in the city of Bombay or Calcutta, Rs. 1 lakh in respect of its principal place of business plus Rs. 10,000 in respect of each of its other places of business situated in the same district in which it has its principal place of business plus Rs 25,000 in respect of each place of business situated elsewhere in the State otherwise than in the same district subject to an overall ceiling of Rs. 5 lakhs. Further, if it has all its places of business in one State, one or more of which is or are situated in the city of Bombay or Calcutta, Rs. 5 lakhs plus Rs. 25,000 in respect of each place of business situated outside the city of Bombay or Calcutta as the case may be and subject to an overall ceiling of Rs. 10 lakhs. In the case of banking companies which commence banking business for the first time after the coming into operation of the Banking Companies (Amendment) Act, 1962, the value of the paid-up capital is required to be not less than Rs. 5 lakhs. Moreover, section 17 of the Banking Regulation Act, 1949 requires every banking company to transfer every year to a reserve fund a sum not less than 20 per cent of its net profit. As a result of consolidation of the banking system by amalgamation or otherwise, there are, at present, very few banks in the country whose aggregate value of the paid-up capital and reserves is less than Rs. 5 lakhs.

5.36 As regards financial companies, we may adopt similar criteria with suitable changes. Taking into account the factors mentioned earlier including their viability, we recommend that every financial company other than a nidhi, which commences business after the regulatory measures proposed by us come into force, shall have a paid-up capital of not less than Rs. 5 lakhs; if such company conducts business only at one place with a population of less than five lakhs, the paid-up capital shall not be less than Rs. 2 lakhs. As regards an existing company other than a nidhi, its net worth (i.e. paid-up capital plus free reserves less the balance of accumulated loss and other intangible assets, if any, as appearing in its latest audited balance sheet) shall not be less than Rs. 2 lakhs, if it conducts its business at only one place with a population of less than five lakhs; in any other case, its net worth shall not be less than Rs. 5 lakhs. Such of the companies as do not comply with the above requirements may be allowed time up to three years for regularising the position; the Reserve Bank may also be authorised to grant further extension of time not exceeding two years for complying with the above requirements.

CREATION OF RESERVE FUND AND RESTRICTIONS ON PAYMENT OF DIVIDENDS

5.37 In view of the risks involved in respect of their loans and advances, we are of the view that financial companies should build up adequate reserves to provide for contingencies such as bad debts, etc. We, therefore, recommend that all types of financial companies (including nidhis) should be required to transfer to the reserve fund a sum equivalent to not less than 20 per cent of their annual net profit before declaring any dividend till such time as the amount in the reserve fund is less than the paid-up capital of the company.

5.38 Further, a financial company (including a nidhi) should be prohibited from paying any dividend on its shares until all capitalised expenses (including preliminary expenses, organisational expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off. Exception may, however, be made in regard to:

(a) depreciation, if any, in the value of its investments in approved securities (i.e. securities in which a trustee may invest money under clauses (a), (b), (bb), (c) or (d) of section 20 of the Indian Trusts Act, 1882) in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

(b) depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the company; and

(c) bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the company.

MAINTENANCE OF LIQUID ASSETS/CASH RESERVES

5.39 In order to ensure that financial companies are in a position to meet their liabilities as and when they accrue, it is desirable that they should maintain at all times a percentage of their deposit liabilities in the form of liquid assets. With this end in view, we recommend that all financial companies (including nidhis) may be required to maintain in a current account or in any other deposit account with a scheduled bank free from any charge or lien, or in unencumbered securities of the Central Government or of a State Government or in other unencumbered securities in which a trustee is authorised to invest trust money (such securities being valued at their market value for the time being) or partly in such account or partly in such securities, a sum which shall not, at the close of business on any day be less than 10 per cent of the deposits received by the company and outstanding in its books on that day. In making the above recommendation, we have

deliberately omitted 'cash in hand' as one of the items constituting liquid assets for the purpose because unlike in the case of banks which accept demand deposits and hence find it necessary to keep cash balances in hand, large amounts of cash in hand will not be necessary for financial companies. In view of our above recommendation, we do not think that there is any necessity of prescribing maintenance of cash reserves by such companies.

5.40 We also recommend that the Reserve Bank may be authorised to vary the liquid assets ratio of NBFCs in accordance with its monetary and credit policy. This will facilitate co-ordination of the direction of credit policies of commercial banks and NBFCs.

PARTICULARS TO BE PRESCRIBED IN ADVERTISEMENTS

5.41 The main intention in requiring a company soliciting deposits from the public to disclose certain particulars in the advertisements issued by it as also in the application forms for acceptance or renewal of deposits is to enable the prospective depositors to have a fair knowledge and assessment of the business of the company, its management and financial position. Having regard to the particulars required to be given in the advertisements as specified in paragraph 5(1) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, we are of the view that every NBFC should disclose some more particulars in the advertisements as also in the application forms for acceptance, renewal or conversion of deposits, as detailed below:

(a) In lieu of the particulars presently referred to in clause (f) of sub-paragraph (1) of paragraph 5, NBFC may be required to give its summarised balance sheet position for the three preceding accounting years.

(b) It may also be required to disclose the amount which it can borrow under the proposed ceiling and the aggregate amount which it has actually borrowed as on a recent date.

(c) Statement to the effect that as on the date of the advertisement, it has no overdue deposits other than unclaimed deposits may be published; if there are any overdue deposits, the amount of such deposits may be given.

(d) Every advertisement shall contain a declaration to the effect that—

(i) the company has complied with the provisions of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966;

(ii) compliance with the said directions does not imply that repayment of deposits is guaranteed by the Reserve Bank; and

(iii) the deposits accepted by the company are unsecured ranking *pari passu* with other unsecured liabilities.

It was observed from the advertisements given by some companies/their

brokers that they contained legends such as "As per Reserve Bank's Directions", "Complied with the Reserve Bank's Directives", etc., giving an impression to the unwary depositors that the companies were accepting deposits with the prior approval of the Reserve Bank. In order to obviate such misleading impression being created in the minds of the public by financial companies and/or their brokers in the advertisements issued by them, the provision as in item (d) (ii) above has been suggested.

5.42 With a view to bringing the provisions of the directions on par with some of the provisions in the Companies (Acceptance of Deposits) Rules, 1975, we recommend that the directions may be suitably amended to provide that—

(i) every NBFC intending to solicit deposits from the public (other than deposits from its directors, shareholders or employees) shall issue an advertisement for the purpose in a leading English newspaper and in one vernacular newspaper circulating in the State in which the registered office of the company is situate;

(ii) an advertisement so issued shall be valid for a period not exceeding six months after the close of the financial year of the company or such extended time as may be allowed by the Registrar of Companies concerned for holding the annual general meeting in terms of the second proviso to section 166(1) of the Companies Act, 1956;

(iii) no advertisement shall be issued by or on behalf of a company unless on or before the date of its issue, there has been delivered to the Reserve Bank a copy thereof signed by the Chief Executive Officer of the company under the authority of its Board of Directors; and

(iv) every change in the particulars contained in the advertisement of which a copy has been filed with the Reserve Bank, shall also be notified to the Bank within thirty days from the date on which such change occurs.

5.43 In terms of section 4 of the Protection of Depositors Act, 1963 of the United Kingdom, private limited companies issuing advertisements for soliciting deposits are deemed to be public limited companies for the purpose of certain provisions of the Companies Act of U.K. Since, in the case of a private limited company, its articles of association (a) restrict the right to transfer its shares, (b) limit the number of its members to fifty excluding its employes, and (c) prohibit any invitation to the public to subscribe for any shares or debentures of the company, its sphere of operations is naturally restricted. Further, the copies of its balance sheet and profit and loss account are filed separately with the Registrar of Companies and no person other than a member can inspect the profit and loss account of the company. In the circumstances, it is but reasonable that if a private limited company is to solicit deposits through advertisements, it should be deemed to be a public limited company for the purpose of certain sections of the Companies Act, 1956. We, therefore, recommend that if a private company, whether financial or non-financial, issues any advertisement soliciting deposits, it shall be deemed

to be a public company for the purposes of sections 198, 220(1), 372 and 373 of the Companies Act, 1956.

5.44 In terms of clause (b) of sub-section (7) of section 58A of the Companies Act, 1956, except the provisions relating to advertisement contained in clause (b) of sub-section (2), nothing in that section shall apply to such classes of financial companies as the Central Government may, after consultation with the Reserve Bank, specify in this behalf; Clause (b) of sub-section (2) of that section provides that no company shall invite, or allow any other person to invite or cause to be invited on its behalf, any deposit unless an advertisement, including therein a statement showing the financial position of the company, has been issued by the company in such form and in such manner as may be prescribed. The cumulative effect of these provisions is that advertisements issued by NBFCs will be regulated by the rules made by the Central Government under section 58A and not under the directions issued by the Reserve Bank. It will, therefore, be necessary to withdraw paragraph 5 of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and extend Rule 4 of the Companies (Acceptance of Deposits) Rules, 1975 to NBFCs. Since, however, our recommendations in regard to advertisements by NBFCs contain certain minor variations from the provisions in Rule 4 *ibid*, the question of prescribing a separate rule under section 58A(2)(b) of the Companies Act for regulating the issue of advertisements by NBFCs may be considered.

5.45 It is not, however, clear to us why in the case of NBFCs, the power to regulate advertisements issued by them has been reserved by the Central Government, while in other respects, the Reserve Bank is the competent authority for regulating the deposit-acceptance activities of such companies. If the intention is to ensure uniformity in the matter of regulation of advertisements soliciting deposits issued by all types of NBCs, this could have been achieved by making identical provisions in the Companies (Acceptance of Deposits) Rules, 1975 and the relative directions by mutual consultations. In fact, we have stressed elsewhere the need to ensure close co-ordination between the Department of Company Affairs and the Reserve Bank in regulating the deposit-acceptance activities of non-banking non-financial and non-banking financial companies respectively. We, therefore, recommend that the words "except the provisions relating to advertisement contained in clause (b) of sub-section (2)" occurring in clause (b) of section 58A(7) of the Companies Act, 1956 may be deleted so that the Reserve Bank shall have powers to regulate the activities of NBFCs including the issue of advertisements by them under the relative provisions of the Reserve Bank of India Act, 1934.

SECURED DEPOSITS

5.46 For the reasons given in paragraph 4.39, we recommend that, by suitably amending the directions, the facility presently available to NBFCs

of receiving 'secured' deposits without any restriction should be totally withdrawn. Companies which have already raised such deposits may be allowed a period of three years from the date of coming into operation of the amendment, for repayment of such deposits and/or regularisation of the position in any other manner.

RISK ASSETS TO BE HELD BY NBFCs

5.47 We do not feel that it is necessary to lay down a norm prescribing the extent to which risk assets may be held by NBFCs. The liquidity ratio as also the limit on borrowings by way of deposits recommended by us would act as an automatic constraint on the extent to which risk assets may be held by them.

LOANS AND ADVANCES TO DIRECTORS, ETC.

5.48 As mentioned earlier, one of the features observed in the case of several NBFCs, especially private limited companies, was that loans and advances had been granted to directors and firms in which they were interested as partners, managers, etc. This is not a desirable feature. We, therefore, recommend that no NBFC shall—

(a) enter into any commitment for granting any loan or advance to or on behalf of—
  (i) any of its directors; or
  (ii) any firm in which any of its directors is interested as partner, manager, employee or guarantor; or
  (iii) any company (not being a subsidiary or a company registered under section 25 of the Companies Act, 1956 or a Government Company) of which any of the directors of the financial company is a director, manager, employee or guarantor or in which he holds a substantial interest; or
  (iv) any individual in respect of whom any of its directors is a partner or guarantor; or

(b) grant any loans or advances on the security of its own shares.

NBFCs which have allowed any of the above types of facilities may, however, be allowed a period of one year for recovery of such outstanding loans or for regularising the position in any other manner.

DISTINCTION TO BE MADE BETWEEN PUBLIC AND PRIVATE COMPANIES FOR THE PURPOSE OF PERIOD OF DEPOSITS AND CEILINGS

5.49 One of the terms of reference requires us to examine and recommend whether any distinction should be made between a public and private limited

company for the purpose of determining the extent to which and the periods for which NBCs may borrow by way of deposits. We are not in favour of making any distinction between private and public limited companies, whether non-financial or financial, in regard to the period of deposits. Under the existing directions, any money received by a private company from its shareholders is exempt from the purview of the term 'deposit' provided that the person from whom the money is received furnishes to the company a declaration in writing that the money has not been given by such person out of funds acquired by him by borrowing or accepting deposits from another person. We have already recommended (see paragraph 5.33) that deposits of shareholders of private financial companies deemed to be public by virtue of section 43A of the Companies Act, 1956 should be given the same treatment as those of other private companies.

ACTIVITIES CARRIED ON THROUGH SUBSIDIARIES

5.50 Another term of reference requires us to make recommendations regarding the extent to which any of the activities carried on by NBCs through their subsidiaries can or should be controlled. If a financial company has a subsidiary carrying on business different from that of the parent company, this may mean locking up of funds of the financial company and may prove to be harmful to the interests of the depositors of the parent company. Also, financial business by its very nature is of a specialised type. For these reasons and following the principle laid down in section 19 of the Banking Regulation Act, 1949, we are of the view that no NBFC other than an investment company but including a nidhi should be allowed to form a subsidiary company except for the purpose of carrying on the same line of business as that of the holding company. Further, no NBFC should be allowed to deal, directly or indirectly, in buying or selling of goods except in connection with the realisation of security given to or held by it. An exception may, however, be made in the case of hire-purchase finance companies which may be allowed to trade in goods in which they also deal on hire-purchase basis.

5.51 We have excluded investment companies (a holding company is also classified as an investment company for the purpose of the directions) from the restrictions contemplated above, in view of the provisions contained in section 372 of the Companies Act, 1956. This section provides that the Board of Directors of a company shall be entitled to invest in any shares or debentures of another body corporate up to 10 per cent of the subscribed capital of the latter, provided that—

(i) the aggregate of such investments made in all other bodies corporate shall not exceed 30 per cent of the subscribed capital of the investing company; and

(ii) the aggregate of such investments made in all other bodies corporate in the same group as the investing company shall not exceed 20 per cent of the subscribed capital of the investing company.

The limit of 30 per cent referred to at (i) above is not, however, applicable to an investment company. Also, the restrictions laid down in section 372 *ibid* are not applicable to investments by a holding company in its subsidiary. The present position may continue.

DEALERSHIP DEPOSITS

5.52 Among the NBFCs, dealership deposits are taken only by hire-purchase finance companies. In paragraphs 4.29 to 4.31, we have explained in detail why, in our view, the exemption granted in respect of security/dealership deposits under the Companies (Acceptance of Deposits) Rules, 1975 may continue. The same reasons hold good in regard to security/dealership deposits accepted by hire-purchase finance companies. We, therefore, recommend that the exemption in respect of such deposits available to NBFCs under the directions may also continue.

EXEMPTION OF CONVERTIBLE DEBENTURES/BONDS FROM THE PURVIEW OF THE TERM 'DEPOSIT'

5.53 The exempted categories of deposits specified in clause (f) of paragraph 2(1) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 do not include moneys raised by issue of convertible debentures/bonds and such moneys come within the purview of the ceiling of 15 per cent of the net owned funds of a company referred to in sub-clause (i) of clause (d) of paragraph 3(1) *ibid* as amended on January 27, 1975. For the reasons detailed in paragraphs 4.32 to 4.34 which also hold good in the case of NBFCs, we recommend that moneys raised by issue of convertible debentures/bonds may be exempted from the purview of the term 'deposit' under the above directions.

ENACTMENT OF PROVISIONS ON THE LINES OF CERTAIN SECTIONS OF THE BANKING REGULATION ACT, 1949

5.54 As stated earlier. most of the financial companies are para-banking institutions which accept deposits for the purpose of lending and/or investment. As such, the activities of these companies in regard to deposits, loans and advances, etc., should be regulated broadly on the lines of the provisions contained in the Banking Regulation Act, 1949. While making our recommendations in regard to capital funds, maintenance of liquid assets, advances to directors, declaration of dividends, etc., we have kept the relevant provisions of the above Act in view. We are further of the opinion

that for the effective regulation of the activities of financial companies, the Reserve Bank should be vested with powers on the lines of the following sections of the Banking Regulation Act:

(i) Section 21: Powers of the Reserve Bank to control advances by banking companies;

(ii) Section 23: Restrictions on the opening of new offices and transfer of existing places of business;

(iii) Section 27(2): Power to call for returns and other information;

(iv) Section 28: Power to publish information;

(v) Section 35A: Power of the Reserve Bank to give directions under certain circumstances such as preventing the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the company, or to secure the proper management of any banking company generally;

(vi) Section 35B: Powers regarding appointment and remuneration of the Chief Executive Officer;

(vii) Sub-section (1) of section 36 excluding clause (c) thereof and sub-section (3) *ibid*: Further powers and functions of the Reserve Bank. These include, *inter alia*, power to—

(a) caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions and generally give any advice to any banking company;

(b) assist the companies concerned as intermediary or otherwise in proposals for amalgamation of such companies;

(c) require a banking company to call a meeting of its directors for the purpose of considering any matter or require an officer of the company to discuss any such matter with an officer of the Reserve Bank;

(d) depute one or more officers to watch the proceedings at any meeting of the Board of Directors of the banking company or of any committee constituted by it;

(e) appoint one or more of its officers to observe the manner in which the affairs of the company or of its offices are being conducted; and

(f) require the company to make, within such time as may be specified in the order, such changes in the management as the Reserve Bank may consider necessary.

(viii) Section 38: Powers to approach the High Court for compulsory winding up of a banking company.

The grounds for approaching the High Court for the compulsory winding up of a NBFC may be all or any one of the following, viz.,

(a) that the company is unable to pay the sums due and payable to its depositors or is able to pay such sums only by obtaining additional deposits or by defaulting in its obligations to its other creditors; or

(b) that the value of the company's assets (excluding intangible assets) is less than the amount of its liabilities; or

(c) that the company has persistently defaulted in complying with any provision of the Reserve Bank of India Act, 1934 and/or the directions issued thereunder relating to the submission of annual accounts, filing of statutory returns or has committed contravention of any other provision of the directions; or

(d) that the company has been prohibited from accepting further deposits in terms of sub-section (4) of section 45K of the Reserve Bank of India Act, 1934; or

(e) that, in the opinion of the Reserve Bank, the continuance of the company is detrimental to the interests of its depositors.

(ix) Section 44A: Procedure for amalgamation of banking companies. Since one of the objectives of having better control over NBFCs is to strengthen their financial position, viability, etc., it may become necessary to bring about amalgamation of companies on a voluntary basis in suitable cases. For this purpose, a self-contained procedure for amalgamation of NBFCs on the lines of section 44A may be provided for.

SUBMISSION OF RETURNS AND THEIR PERIODICITY

5.55 For the purpose of verifying how far NBFCs comply with the various provisions of the new regulatory measures that would be formulated in the light of our recommendations, it might be necessary to prescribe suitable forms of returns to be submitted by them. Further, the periodicity for the submission of some of the returns will also have to be made more frequent. Depending upon which of the recommendations made by us are acceptable to the Reserve Bank, it may prescribe the necessary forms for submission of the requisite statistical data and other information at specified intervals for watching compliance with the various provisions.

ENACTMENT OF SEPARATE LEGISLATION

5.56 It will be seen from the foregoing that we have made a number of recommendations for tightening up of the controls over the deposit-accept-

ance activities as also other operational aspects of the working of NBFCs. In view of the substantive nature of the recommendations and also the fact that the deposit-acceptance activities of non-financial companies are no longer under the control of the Reserve Bank, we feel that it would be desirable to enact separate comprehensive legislation in the place of Chapter IIIB of the Reserve Bank of India Act, 1934 for giving effect to the recommendations. Pending enactment of such legislation, the existing provisions of Chapter IIIB *ibid* may be invoked for issuing directions in respect of such of the recommendations as could be implemented without waiting for the enactment of separate legislation. In view of the foregoing, the Study Group does not consider it necessary to make any recommendations at this stage for amending the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934.

AMENDMENTS TO THE DIRECTIONS ISSUED TO NBFCs

5.57 Apart from the amendments which may have to be made to the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 in the light of our recommendations, we feel that certain further amendments would also be necessary. These are detailed below:

(i) The intention in making the provision as in the Explanation to paragraph 4 of the directions for deducting the balance of carried forward loss, if any, as appearing in the balance sheet of a company from its paid-up capital and free reserves is to ensure that only its net owned funds are taken into account for the purpose of working out the ceilings available to NBFC in regard to the quantum of deposits which it may accept. It is observed that companies sometimes carry in their books other intangible assets such as goodwill and deferred revenue expenditure. It would be unrealistic not to take these fictitious assets also into account for the purpose of arriving at the net owned funds of a company. Hence, the words 'goodwill, deferred revenue expenditure and other intangible assets' may be inserted after the words 'accumulated balance of loss' occurring in the Explanation to paragraph 4 of the directions. This amendment would also bring the provision in the directions on par with Explanation 2 to Rule 3 of the Companies (Acceptance of Deposits) Rules, 1975;

(ii) (a) With a view to ensuring that the provisions relating to the premature repayment of deposits are generally in line with the directives* issued by the Reserve Bank to commercial banks, clause (a) of paragraph 9 of the directions may be amended to provide that in respect of any deposit which is repaid before the date on which it is due for repayment but on or after the expiry of six months from the date of receipt of such deposit, the rate of interest payable by NBFC on such deposit, shall be 2 per cent lower

* See paragraph 4.44.

than the relative rate for the period nearer to the completed year for which the deposit has run or is about to run. For example, if a three-year deposit is prematurely repaid at the end of 14 months, the rate of interest payable will be the rate applicable for one-year deposit less 2 per cent; if such deposit is repaid at the end of 18 months, the rate of interest payable will be as for a two-year deposit less 2 per cent.

(b) Clause (b) of paragraph 9 of the directions provides that in respect of any deposit which is repaid within periods ranging between fourteen days and six months from the date of receipt, there shall be paid interest not exceeding the rates specified therein. In terms of the proviso thereto, nothing contained in paragraph 9 shall apply where the terms and conditions governing the deposit provide for earlier repayment of the deposit at the option of the financial company and the deposit is paid earlier pursuant to such option. Since the intention underlying clause (a) of paragraph 9 *ibid* of ensuring that financial companies do not accept deposits for periods less than six months would be negatived by the provision in clause (b) and enable companies to convert time deposits into short-term/demand deposits (the acceptance of which is the legitimate function of banks), it is suggested that clause (b) of paragraph 9 as also the proviso thereto may be deleted.

CONVERSION OF CERTAIN TYPES OF FINANCIAL COMPANIES INTO BANKS

5.58 Loan companies and nidhis are 'incipient' banks and there is hardly any distinction in their methods of operation and those of commercial banks. In fact, many of the loan companies were functioning as banks till a couple of decades ago. However, with the enactment of the Banking Regulation Act in 1949, these companies found it difficult to comply with the restrictions imposed upon them and/or were refused licence to carry on banking business and consequently converted themselves into NBCs. With the proposed enactment of comprehensive legislation to regulate the working of NBFCs, their functioning would, in due course, come on par with that of banks. In that eventuality, such of the companies as are in a position to comply with the requirements laid down by the Reserve Bank should be enabled to convert themselves into full-fledged commercial banks. Such a step would ensure strengthening of the financial system of the country. We, therefore, suggest that suitable provisions should be made in the proposed legislation to enable the above types of companies to convert themselves into commercial or co-operative banks subject to such conditions as the Reserve Bank may impose.

AUTHORITY FOR ADMINISTERING THE DIRECTIONS/ PROPOSED LEGISLATION

5.59 Another question which needs to be considered is whether the various provisions of the directions or of the comprehensive legislation regu-

lating the working of NBFCs, when enacted, should be administered by the Reserve Bank or whether a separate authority should be constituted for the purpose. According to our recommendations, the working of NBFCs is proposed to be regulated by making suitable provisions on the lines of those contained in the Banking Regulation Act, 1949 which is being administered by the Reserve Bank. During the course of the enforcement of that Act, the Reserve Bank has built up considerable expertise in the matter of regulation of the activities of banking companies. Moreover, NBFCs accepting deposits are, by and large, counterparts of banks in the non-banking sector and their activities will, in the light of our recommendations, have to be regulated broadly in the same manner as those of banking companies. The main objectives of regulating the working of NBFCs are to ensure that their activities are in tune with the monetary and credit policy laid down by the Reserve Bank and also to afford a degree of protection to the depositors' funds. Since the Reserve Bank is already discharging these functions in regard to commercial and co-operative banks, we are of the view that the appropriate authority for regulating the activities of NBFCs should also be the Reserve Bank. The administrative arrangements which will have to be made for implementing our recommendations have been outlined in Chapter 7.

CHAPTER 6

MISCELLANEOUS NON-BANKING COMPANIES

INTRODUCTION

6.1 Miscellaneous non-banking companies covered by the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 are of two types, viz.,

(a) those conducting prize chits, benefit/savings schemes, lucky draws, etc.; the *modus operandi* of the types of schemes conducted by these companies has been set out in a subsequent paragraph; and

(b) those conducting conventional or customary chit funds whereunder the foremen companies enter into agreements with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscriber shall in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreements, be entitled to the "prize amount". This prize amount is arrived at by deduction from out of the total amount subscribed at each instalment by all subscribers, (i) the commission charged by the company or service charges as a promoter or a foreman or an agent and (ii) discount, i.e., any sum which a subscriber agrees to forego, from out of the total subscriptions of each instalment in consideration of the balance being paid to him. The saving and credit aspects of chit funds have been discussed later.

GENESIS OF THE MISCELLANEOUS NON-BANKING COMPANIES (RESERVE BANK) DIRECTIONS, 1973

6.2 Prior to the amendment of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 in November 1972 and August 1973 respectively, companies conducting prize chits/benefit schemes as also those conducting conventional chits used to be classified for the purpose of the said directions either as chit fund or loan or mutual benefit financial or miscellaneous financial companies as the case may be, having regard to the pattern of their assets and the nature of income derived by them. Subscriptions received by conventional chit fund companies under the schemes conducted by them as also deposits accepted by mutual benefit financial companies did not come within the purview of the directions and were thus not subject to any ceiling restrictions. It was observed that several companies conducting prize chits, benefit or savings schemes or lucky draws claimed themselves to be either mutual benefit financial companies (by enrolling

subscribers as 'associate' members under the directions as they stood prior to January 1, 1973) or as chit fund companies and thus contended that the subscriptions collected by them were not 'deposits' as defined in the directions and hence not subject to any ceiling restrictions. With a view to putting the matter beyond doubt and since it was observed that this type of companies had not been adequately covered by the directions issued to financial companies, the Reserve Bank issued on August 23, 1973 a new set of directions known as the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 which came into force from September 1, 1973. These directions, as stated earlier, are applicable to companies conducting what are commonly known as prize chit schemes/benefit or savings schemes or lucky draws and also to those conducting conventional type of chits or those conducting any other form of chits/kuris which are different from those referred to above or engaged in or executing any other business similar to the types of business mentioned above.

MODUS OPERANDI OF PRIZE CHITS/BENEFIT OR SAVINGS SCHEMES OR LUCKY DRAWS

6.3 Companies conducting the above types of schemes are comparatively of a recent origin and of late, there has been a mushroom growth of such companies which are doing brisk business in several parts of the country, especially in big cities like Ahmedabad, Bangalore, Bombay, Calcutta and Delhi. They have also established branches in various States. These companies float schemes for collecting money from the public and the *modus operandi* of such schemes is generally as described below:

The company acts as the foreman or promoter and collects subscriptions in one lump sum or by monthly instalments spread over a specified period from the subscribers to the schemes. Periodically, the numbers allotted to members holding the tickets or units are put to a draw and the member holding the lucky ticket gets the prize either in cash or in the form of an article of utility, such as a motor car, scooter, etc. Once a person gets the prize, he is very often not required to pay further instalments and his name is deleted from further draws. The schemes usually provide for the return of subscriptions paid by the members with or without an additional sum by way of bonus or premium at the end of the stipulated period in case they do not get any prize. The principal items of income of these companies are interest earned on loans given to the subscribers against the security of the subscriptions paid or on an unsecured basis as also loans to other parties, service charges and membership fees collected from the subscribers at the time of admission to the membership of the schemes. The major heads of expenditure are prizes given in accordance with the rules and regulations of the schemes, advertisements and publicity expenses and remuneration and other perquisites to the directors.

6.4 It may, at this stage, be useful to examine the financial implications

of the schemes conducted by prize chit companies. One typical scheme* is as follows:

There are 10,000 members each contributing Rs 15 per mensem for a period of 25 months. The scheme is of a duration of 70 months during which period the company will disburse prizes totalling Rs 3.80 lakhs to the lucky prize winners at the periodical draws. After 70 months, all the members will get back their subscriptions of Rs 375 each cumulatively amounting to Rs 37.5 lakhs. The table given below shows the details regarding the generation of interest on the monthly collections:

TABLE 6.1—GENERATION OF INTEREST IN A BENEFIT SCHEME LASTING FOR 70 MONTHS

Instalment No.	Period for calculation of interest (months)	Collection from 10,000 members (Rs lakhs)	Simple interest earned during the scheme @ 12% p.a. (Rs lakhs)	Cumulative balance with the promoter excluding interest (Rs lakhs)
(1)	(2)	(3)	(4)	(5)
1	69	1.5	1.04	1.5
2	68	1.5	1.02	3.0
3	67	1.5	1.01	4.5
4	66	1.5	0.99	6.0
5	65	1.5	0.98	7.5
6	64	1.5	0.96	9.0
7	63	1.5	0.94	10.5
8	62	1.5	0.93	12.0
9	61	1.5	0.92	13.5
10	60	1.5	0.90	15.0
11	59	1.5	0.88	16.5
12	58	1.5	0.87	18.0
13	57	1.5	0.86	19.5
14	56	1.5	0.84	21.0
15	55	1.5	0.82	22.5
16	54	1.5	0.81	24.0
17	53	1.5	0.80	25.5
18	52	1.5	0.78	27.0
19	51	1.5	0.76	28.5
20	50	1.5	0.75	30.0
21	49	1.5	0.74	31.5
22	48	1.5	0.72	33.0
23	47	1.5	0.70	34.5
24	46	1.5	0.69	36.0
25	45	1.5	0.68	37.5
			21.39	

*Source: Paper entitled 'Chit Funds and Lottery Chit Schemes: Relevance and Scope' presented by Dr. C. P. S. Nayar at the seminar on Chit Funds and Finance Companies/Corporations held in Madras in October 1974 under the auspices of the Institute for Financial Management and Research.

During the course of the scheme, the promoter company is thus able to collect Rs 21.39 lakhs by way of interest at an assumed simple rate of 12 per cent per annum on the monthly balances left with it. After disbursing prizes worth Rs 3.80 lakhs, it will be left with a surplus of Rs 17.59 lakhs.

6.5 The above example is based on the assumption that the scheme is fully subscribed and all members continue to pay their subscriptions for the entire period of 25 months. Even if the company offers some amount by way of bonus or premium to the subscribers at the time of refund of their subscriptions and allowing for reasonable expenditure on publicity, commission to agents, etc., a sizeable balance will still be left with the company. This is exclusive of the amounts which the company might be collecting by way of membership fees and service charges from the subscribers and also of the amounts which it might be appropriating in respect of the subscriptions on forfeited tickets on which there will be no future liability for refund to the members at the end of the scheme. It will thus be obvious from the foregoing that such schemes confer monetary benefit only on a few members and on the promoter companies.

WEAKNESSES OF PRIZE CHIT COMPANIES

6.6 Most of these institutions are private limited companies with a very low capital base amounting to a few thousand rupees, contributed by the promoters/directors or their close relatives. A study conducted by the Reserve Bank of 71 prize chit companies whose balance sheets (though of different dates) were available, revealed that as against their aggregate paid-up capital and reserves amounting to Rs 41.9 lakhs, the balance of the carried forward loss amounted to Rs 90.8 lakhs. The subscriptions collected by these companies for the various schemes conducted by them aggregated Rs 1647.2 lakhs. It would thus be seen that not only the paid-up capital and reserves had been completely wiped off but also the subscriptions aggregating Rs 48.9 lakhs had been eroded. The companies thus had absolutely no stake of their own in the business and were solely dependent on public funds. This was mainly due to the high expenditure incurred by the companies on advertisements and commission paid to the agents. The inspection of a few companies conducting prize chit/benefit schemes, carried out by the Reserve Bank revealed, *inter alia*, the following features:

(a) the companies had advanced sizeable amounts to the directors or their relatives or firms in which they were interested as partners, directors or as commission agents and there were practically no repayments of the loans;

(b) the books of account had not been maintained satisfactorily;

(c) close relatives of the directors had been employed in the companies as members of the staff or as agents on high salaries;

(d) in one case, it was observed that a scheme announced by a company in which collections had been made was withdrawn subsequently without notice to the subscribers and no refunds of the subscriptions already received had been made to the subscribers. Prize moneys had not been paid to all the subscribers who had won the prizes; and

(e) subscriptions were shown to have been refunded in the books of account of a company but doubts have been expressed by the Inspecting Officer about the genuineness of the payments in view of certain attendant circumstances. There have also been allegations that some companies had resorted to certain malpractices in drawing the names of prize winners.

NATURE OF THE SUBSCRIPTIONS RECEIVED IN PRIZE CHIT/ BENEFIT SCHEMES AND FUTURE OF SUCH SCHEMES

6.7 Subscriptions accepted in the various types of prize chit schemes are 'deposits' under the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 and are consequently subject to the ceiling restrictions prescribed in paragraph 4 of the directions. Since most of the companies have exceeded the ceiling on account of carried forward balances of accumulated loss, they are not in a position to accept further subscriptions. Some of the companies are stated to have contended that subscriptions received in their schemes are not 'deposits' as defined in the directions. Apart from the question whether or not this contention is tenable, it may be pointed out that a new definition of the term 'deposit' has been inserted as clause (bb) in section 45I of the Reserve Bank of India Act, 1934 by the Reserve Bank of India (Amendment) Act, 1974. The term 'deposit' as now defined includes "and shall be deemed always to have included, any money received by a non-banking institution by way of deposit, or loan or in any other form, but shall not include amounts raised by way of share capital or contributed as capital by partners of a firm".

6.8 It may be mentioned that the Banking Commission has pointed out (see paragraph 17.44)* that the running of prize chits amounts to commission of an offence of running a lottery under section 294A of the Indian Penal Code; however, the police regard this as a civil transaction and the offence remains a non-cognizable one. The Commission has further observed that as the law prohibits running of prize chits, what could be considered is only the adequacy of the machinery for effective enforcement of the legal bar against prize chits and that this is necessary in the public interest and in the interest of those who participate in the prize chit schemes. As prize chits are conducted on a fairly large scale, the Commission has recommended that appropriate legislative measures should be taken in respect of

* Government of India, Report of the Banking Commission (1972); Page 428.

them and also that the offence under section 294A *ibid* should be made a cognizable one.

6.9 Besides section 294A of the Indian Penal Code, some States have enacted or are contemplating to enact legislations of their own for dealing with lotteries and schemes of the type under consideration. For example, the Bombay Lotteries (Control and Tax) and Prize Competition (Tax) Act, 1958 enacted in the erstwhile Bombay State, which, *inter alia,* repeals section 294A of the Indian Penal Code, (in its application to Maharashtra and Gujarat States) is presently in force in the States of Maharashtra and Gujarat. Hence, the problem seems to be one of vigorous enforcement of the existing provisions of the law. We, however, understand that some criminal courts have taken the view that prize chit/benefit schemes are not in the nature of lotteries. But in the absence of any authoritative judicial pronouncement on the subject, we are not sure whether the activities of companies conducting prize chits, etc., are clearly prohibited by the existing legislations.

6.10 It has been reported that the resources of prize chits are used for wasteful spending and hoarding commodities and that these schemes "enable certain persons to convert tax-evaded income into accounted money. The persons concerned pay a premium to the promoters in return for the facility". It has also been stated that "there are a number of agents who go about contacting persons who are likely to face the problem of saving their income from the tax authorities. The prize chit pass books issued to them under different names become their passports for travelling from black money territory to the white money area—the easiest and surest way of using illgotten wealth. Besides, by their misleading names and campaigns the prize chit companies divert private savings into their personal drains, thus disrupting the national economy"*

6.11 From the foregoing discussion, it would be obvious that prize chits or benefit schemes benefit primarily the promoters and do not serve any social purpose. On the contrary, they are prejudicial to the public interest and also adversely affect the efficacy of fiscal and monetary policy. There has also been a public clamour for banning of such schemes; this stems largely from the malpractices indulged in by the promoters and also the possible exploitation of such schemes by unscrupulous elements to their own advantage. We are, therefore, of the view that the conduct of prize chits or benefit schemes by whatever name called should be totally banned in the larger interests of the public and that suitable legislative measures should be taken for the purpose if the provisions of the existing enactments are considered inadequate. Companies conducting prize chits, benefit

* Source: K. Balakrishna—"Prize Chit Racket", Economic Times dated June 30, 1974.

schemes, etc., may be allowed a period of three years which may be extended by one more year to wind up their business in respect of such schemes and/or switch over to any other type of business permissible under the law.

CONVENTIONAL CHIT FUNDS

6.12 We may now turn our attention to what are commonly known as conventional chit funds or kuris. These can be broadly classified into two categories, viz., (i) Simple chits and (ii) Auction chits. In a simple chit, the total contribution made by the members at each draw is given as a prize to one of the participating members drawn by lot. On the other hand, in an auction chit, the total amount collected at each draw is put to auction and the member who is prepared to forego the highest amount of discount (which is usually subject to a ceiling) is entitled to the prize amount. The amount thus foregone, which represents the difference between the total subscriptions of each instalment and the amount of the bid, is distributed among the prized and/or non-prized subscribers (depending on the relative provision, if any, in the chit legislation or in the chit agreement) after deducting the foreman's commission and expenses of conducting the chit. Chit funds are indigenous institutions, which are popular in the Southern States of Kerala, Tamil Nadu and Andhra Pradesh; they pre-date the spread of modern banking and are now spreading to other parts of the country also. Their popularity does not seem to have in any way diminished despite the spread of banking.

6.13 Chit funds constitute convenient instruments combining saving and borrowing. The mechanism of chit fund schemes involves (a) the pooling of resources of a group of individuals (savers), (b) the loaning out of the amounts thus collected either by drawing of lots or by auction to one of the members (borrower) of the group, and (c) the continuance of this process of collection and distribution till the termination of the stipulated period of the schemes. The rationale of chit funds is that they bring the borrowing class directly in contact with the lending class. The borrowers and the investors meet to fix the rate of interest (which is represented by the amount of discount agreed to be foregone by the bidder in consideration of his receiving the prize amount) and since there could be more than one bidder at each draw, a competitive rate of interest (i.e., discount offered subject to the maximum, if any, fixed by the law or under the chit agreement) is offered. The competition is, however, confined to the members of a group and the benefits of the scheme are shared only by such members. In other words, in the case of chit funds, the savers as well as the borrowers are put together and they are allowed to save or borrow for a pre-determined term, the rates of interest being fixed on the principle of demand for and supply of funds in the same group. Chit fund schemes are of a self-liquidating nature and partake the character of mutual benefit schemes.

6.14 On the question of end-use of funds disbursed as prize amounts, there are conflicting views. The Banking Commission has come to the conclusion that the likelihood of the prize monies being put to productive use is small, since a "prospective producer would not depend on the uncertainties involved in a chit fund"*. Whatever be the position, the fact remains that the savings mobilised by chit funds and disbursed by them by way of prize amounts do satisfy the felt needs of a section of the community. Since chit funds as institutions have come to stay and have shown increasing popularity, ways and means have to be found to regulate their working so as to ensure that they function on sound lines and the malpractices, usually observed in the conduct of chits are obviated to the extent possible.

NEED FOR REGULATORY MEASURES AND THE PRESENT POSITION OF CHIT LEGISLATION

6.15 Chit funds are open to abuse by the foreman who may resort to unfair methods for securing illegal gains. Such unfair methods include enrolment of fictitious members to complete the required number of members in a chit series. Similarly, a needy non-prized member may be exploited so that he gets the prize only at the maximum discount. Delaying tactics may be adopted by the foreman in disbursing the prize amount to prized subscriber on the ground that the security offered by him is not acceptable or adequate. Meanwhile, the foreman may use the prize money interest-free. If he succeeds in delaying payment till the succeeding draw, the earlier prize winner can be given the prize out of the collections of the succeeding draw. Thus, one instalment can always remain in the hands of the foreman to be utilised in any way he likes. The above malpractices are only of an illustrative nature and while framing the regulatory measures, such malpractices will have to be kept in view so as to minimise their occurrence.

6.16 Regulation of chit funds is generally considered as a State subject and pursuant to this position, States like Tamil Nadu and Andhra Pradesh have enacted the necessary legislation. The Tamil Nadu Chit Funds Act, 1961 has been adopted in the Union Territory of Delhi with certain modifications with effect from July 5, 1964. In Kerala, the Travancore Chittis Act, 1945 and the Cochin Kuris Regulations, 1932 are in force in the erstwhile Travancore and Cochin States areas respectively, but the Malabar area has no chit legislation. The Kerala Chittis Bill, 1972, a consolidating measure, which will extend to the whole of Kerala has recently been passed by the State Legislature. Chit fund legislation has also been enacted by the Union Territory of Goa, Daman and Diu. In Maharashtra, a Bill to regulate chit funds has been passed by the State Legislature and certain

* Government of India, Report of the Banking Commission (1972); Paragraph 17.41.

States like Karnataka, Gujarat, Punjab and Uttar Pradesh have drafted the necessary Bills.

NEED FOR UNIFORM CHIT LEGISLATION

6.17 It will be seen from the foregoing that chit fund legislation has been enacted only in a few States/Union Territories. There is also a diversity of the regulatory provisions made in the various enactments. It is not, therefore, unlikely that unscrupulous promoters or chit companies might exploit the situation by conducting chits in such of the States as have no chit legislation or in States where the provisions of such legislation are less rigorous. In fact, it was brought to the notice of the Group during the course of its discussions in New Delhi that a number of chit fund companies had shifted their registered offices from the Delhi area to the nearby places in Haryana (where there is no chit legislation) with a view to avoiding compliance with the provisions of the Tamil Nadu Chit Funds Act, 1961 as extended to the Union Territory of Delhi. In the circumstances, the need for enactment of a uniform legislation applicable to chit fund institutions throughout the country cannot be underestimated.

6.18 In the context of the recommendations of the Banking Commission in regard to regulating the activities of non-banking financial intermediaries, the Central Government has, *inter alia*, decided that a model law to regulate chit business may be formulated for adoption by all the States which have no such legislation. It has also decided that the question of making it a requirement of law that only public limited companies should run chit funds should be examined. Pursuant to the above decisions, the Reserve Bank has, at the instance of the Central Government, drafted a Model Bill which was referred to the Group for its comments in October 1974. The draft Bill is generally on the lines of the Andhra Pradesh Chit Funds Act, 1971 (which itself follows the pattern of the Tamil Nadu Chit Funds Act, 1961) and the Kerala Chittis Bill, 1972 as reported by the Select Committee. Besides the usual provisions found in the existing State enactments, certain additional provisions have been made therein. We have examined the provisions of the Model Bill and after taking into account the opinions expressed by the representatives of some of the State Governments which have enacted legislation regulating chit funds in their respective States as also certain individuals having intimate knowledge of the running of chits, our views in this regard have already been conveyed to the Reserve Bank by a letter dated June 30, 1975* addressed by the Chairman of the Group to Shri S. S. Shiralkar, Deputy Governor of the Reserve Bank of India. It will be seen therefrom that the main recommendations of the Study Group are as under:

(a) Since the legal opinion is that Parliament is competent to enact the

* See Appendix VIII.

chit legislation in view of the provision contained in Entry 7 of List III (Concurrent List) of Schedule VII to the Constitution of India, the proposed Bill should be enacted as a Central legislation. Such a step would, besides ensuring uniformity in the provisions applicable to chit fund institutions throughout the country, also prevent such institutions from taking undue advantage either of the absence of any law governing chit funds in any State or exploit benefits of any lacuna or relaxation in any State law by extending their activities to such States;

(b) While the Bill should be enacted as a Central Act, its administration should be left to the State Governments concerned which, in turn, may seek the advice of the Reserve Bank on policy matters. [For the purpose of tendering advice to the Central or State Governments, the Reserve Bank may have to inspect chit fund institutions on a selective basis to have an idea of their working including their methods of operation. Chit funds are "financial institutions" as defined in clause (c) of section 45I of the Reserve Bank of India Act, 1934. Hence, it would be open to the Reserve Bank to undertake inspections of chit fund institutions whenever deemed necessary in exercise of the powers vested in it under section 45N *ibid*];

(c) as regards the question whether only public limited companies should be allowed to conduct chit funds, the Group is of the view that there should be no objection, in principle, to chits being conducted by private limited companies also, and on a limited scale, even by unincorporated bodies such as individuals/sole proprietorships/partnership firms. It might be of relevance to note in this connection that the enactments regulating chit funds in force in certain States do not prohibit chit funds being conducted by unincorporated bodies; and

(d) having regard to the nature of their business, there is no necessity for chit fund institutions to borrow from the public by way of deposits and as such they may be prohibited from accepting deposits except as advance payment of subscriptions or deposits from prized subscribers by way of security towards payment of their future instalments.

6.19 The views of the Group on certain other issues which arose for consideration are given in the Annexure to the above letter dated June 30, 1975*. These are summarised below—

(i) Conduct of other business by chit fund institutions: Chit fund institutions may be prohibited from conducting any other type of business except chit business or granting of loans to subscribers against their paid-up subscriptions.

(ii) Utilisation of funds: Chit fund institutions should utilise their surplus funds only for giving loans or advances to non-prized subscribers

* See Appendix VIII.

against the security of the subscriptions paid by them or investing in trustee securities or in deposits with the approved banks.

(iii) Restriction on the opening of new places of business: Chit fund companies should obtain the prior approval of the Director of Chits within whose jurisdiction their registered offices are situated. The Director of Chits should take certain criteria into account before granting permission for the opening of offices. Unincorporated bodies should not be allowed to conduct business at more than one place.

(iv) Maximum duration of chits: The duration of chits should not ordinarily exceed five years; but chits of a longer duration up to ten years may be started in very special cases only by chit fund companies/banks with the prior approval of the State Government concerned which should take into account factors such as the financial position and methods of operation of the company in question, interests of the prospective subscribers, requirements as to security, etc. (The security deposit to be kept by the foreman company in the case of chits of longer duration may be proportionately higher).

(v) Mode of settlement of disputes: The machinery for settlement of disputes arising between the foreman and the subscribers relating to the adequacy of security offered by prized subscribers to the foreman for payment of future instalments, substitution of subscribers in case of default, etc., should be self-contained, cheap and expeditious on the lines of the machinery prescribed under the State co-operative laws for settlement of disputes by arbitration.

(vi) Ceilings in respect of the aggregate amount of chits that may be conducted at any point of time: The aggregate amount of chits conducted by a chit fund company at any point of time may not exceed 50 per cent of the net worth of company, i.e., the paid-up capital plus free reserves less the balance of accumulated loss and other intangible assets such as deferred revenue expenditure and goodwill, if any. In the case of commercial banks conducting chit funds, no ceiling on the aggregate amount of chits that may be conducted at any point of time need be prescribed since these chits are subject to the close scrutiny of the Reserve Bank. As regards chit funds conducted by unincorporated bodies such as individuals, sole proprietorships and partnerships, the aggregate amount of chits should not, at any point of time, exceed Rs 10,000.

(vii) Minimum capital requirements and the creation of a reserve fund: The minimum paid-up capital of chit fund companies incorporated under the Companies Act, 1956, whether private or public, should be Rs 1 lakh. Companies having paid-up capital of less than Rs 1 lakh may be allowed time up to three years to increase their paid-up capital to the minimum referred to above. The State Government concerned may be authorised to

grant extension of time for a period not exceeding two years in appropriate cases. These companies should also be required to credit 20 per cent of their annual net profits to a reserve fund.

6.20 With the enactment of suitable legislation incorporating the necessary provisions in the light of the views expressed by the Group, it may be expected that the malpractices indulged in by foremen would, by and large, be obviated.

CONCLUSION

6.21 It will be seen from the foregoing that the Group has recommended that the conduct of prize chits by whatever name called should be totally banned in the larger interests of the public and that suitable legislative measures should be taken for the purpose if the provisions of the existing enactments are considered inadequate.

6.22 Under the present directions, subscriptions received by companies conducting conventional chits are exempt and only deposits accepted by such companies are subject to the ceiling restrictions. We have, however, recommended that institutions conducting conventional chit funds should be prohibited from accepting deposits except as advance payment of subscriptions or deposits from prized subscribers by way of security towards payment of their future instalments. If this recommendation is accepted, chit funds will go out of the purview of the directions issued by the Reserve Bank. In view thereof and since the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 seek to regulate the deposit-acceptance activities of companies conducting prize chit, benefit or savings schemes and also conventional chits, we have not examined the provisions of the said directions. It may, however, be pointed out that since these directions generally follow the pattern of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, our suggestions for making further amendments to the directions issued to financial companies would, with minor changes, hold good in the case of the directions issued to miscellaneous non-banking companies. Pending decision on the recommendations and enactment of legislation in regard to prize chits and conventional chit funds, the desirability of suitably amending the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 may be considered by the Reserve Bank.

CHAPTER 7

ADMINISTRATIVE ARRANGEMENTS

INTRODUCTION

7.1 In this chapter we propose to deal with the measures that may have to be taken to strengthen the administrative arrangements for implementing the recommendations made by us. In the context of the bifurcation of responsibility between the Reserve Bank and Central Government in regard to the exercise of control over deposit-acceptance activities of NBCs, it would also be necessary to have a close liaison between the two authorities. We propose to consider in the first instance the administrative arrangements that would have to be made by the Reserve Bank for the exercise of effective supervision over the working of the financial companies so that they operate as an integral part of the credit system. In regard to non-financial companies, the Reserve Bank is expected to play a consultative role in the making of rules under section 58A of the Companies Act, 1956; it would, therefore, have to keep itself apprised of the trend of deposits with non-financial companies and its impact on the monetary and credit policy. Before considering the question of the administrative measures to be taken by it for effectively discharging the functions that would continue to vest with it and those additionally devolving on it, it would be relevant to review the existing arrangements in the Department of Non-Banking Companies (DNBC) of the Reserve Bank in this regard.

SETTING UP OF DNBC

7.2 DNBC was created in March 1966 with its Central Office in Calcutta as a nucleus for the development of a full-fledged department for administering the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 and the directions issued thereunder. It had till recently no regional office. However, a Cell was opened in Bombay since October 1974, for attending to certain selected items of work.

FUNCTIONS ASSIGNED TO DNBC

7.3 When the Department was initially set up, the main functions assigned to it were:

(i) to study and analyse balance sheets as well as the returns filed by individual companies in the non-banking sector and to locate companies revealing a generally unsatisfactory position;

(ii) to establish an inspection wing to carry out inspections of the

financial affairs of companies whenever found necessary and to initiate appropriate measures from time to time vis-a-vis the individual companies;

(iii) to conduct every half-year surveys of deposits with NBCs, scrutinise the returns received in this connection, carry on correspondence in respect of inadequately filled or inaccurate returns and secure a tabulation of the data;

(iv) to make a study of the trends revealed by the working of NBCs on the basis of balance sheets received from them and, in the light of these, modify the existing controls or introduce new ones;

(v) to have a general liaison with the Department of Company Affairs to achieve co-ordination;

(vi) to study operations of NBFIs in other countries and also the measures for their regulation to provide an adequate background; and

(vii) to consider the feasibility of extending control over registered firms (with capital of Rs 1 lakh and over) after the present control over the non-banking corporate sector is made effective.

7.4 DNBC also tenders advice in regard to legislation or amendments to the existing legislation regulating chit funds and money-lending activities and obtains information from the various State Governments on the administration of their local money-lending enactments.

ADMINISTRATIVE SET-UP OF DNBC AND THE FUNCTIONS PRESENTLY PERFORMED BY IT

7.5 The Central Office of DNBC is divided into six sections as under:

(i) Non-Financial Institutions Section

(ii) Financial Institutions Section

(iii) Co-ordination, Legislation and Statistics Section

(iv) Inspection Section

(v) Prosecution Section

(vi) Administration Section

7.6 The first two sections are concerned with the scrutiny of returns received from non-financial and financial companies respectively, and deal with the correspondence emanating from such scrutiny. Besides, they attend to queries from companies seeking clarification in regard to the directions and process the applications received from companies for exemption/extension of time for complying with the directions. Advertisements/application

forms issued by companies soliciting deposits are also scrutinised by these sections.

7.7 The Co-ordination Section attends to the work relating to consolidation of the returns and publication of the results of the survey with reference to the position of deposits held by companies as on March 31, every year. In addition, the section deals with matters relating to the interpretation of the provisions of the directions administered by the Department and study of the chit fund and money-lending enactments of various States.

7.8 The Inspection Section processes the reports on the inspections of NBFCs carried out by the Bank and takes necessary follow-up action. We understand that it has, however, not been able to undertake inspections on a regular and continuing basis and that the inspections conducted so far have generally been done by officers deputed by the Department of Banking Operations and Development of the Bank and occasionally by deploying officers from DNBC on an *ad hoc* basis. The section also deals with complaints received from depositors alleging non-payment of their deposits/ interest due thereon. However, the scope of the control administered by the Reserve Bank is confined to protecting the interests of depositors only in an indirect manner by restricting the acceptance of deposits within the prescribed ceilings and by ensuring that information regarding management and financial position is made available by the companies to the intending depositors. The Reserve Bank has taken the view that the acceptance of deposits by a company and their repayment are matters of contract between the depositor and the depositee company and in case of any breach of contract the remedy open to the depositor is to enforce his rights through a court of law; hence it cannot compel repayment of the dues but can employ only persuasive methods by taking up the non-payment with the company concerned.

7.9 We were told that since many companies were not aware of their statutory obligations about filing the returns and balance sheets with Reserve Bank, the Department's efforts were initially directed towards educating the companies in this regard. Since, even after six years of the coming into force of the scheme of control, the response was not to the desired extent, the nucleus of a Prosecution Section was set up in December 1972 with a view to prosecuting such of those companies as had not submitted the returns/balance sheets or had contravened the provisions relating to ceiling restrictions, tenure of deposits, advertisements, etc.

7.10 The Administration Section deals with routine matters relating to the administration of the Department and its staff.

7.11 The Department is under the overall charge of a Chief Officer who

is assisted by two Assistant Chief Officers at the Central Office and another Assistant Chief Officer in charge of the regional Cell in Bombay. The particulars of the staff position of the Department are given in Appendix IX.

ASSESSMENT OF ITS PERFORMANCE

7.12 When DNBC started functioning in March 1966, it had only about 3,000 companies (both financial and non-financial) on its mailing list. The number has since increased to 4,090 non-financial and 1,576 financial companies of which 2,376 and 797 respectively, have submitted the prescribed returns as on March 31, 1974. As the number of non-financial and financial companies (excluding banking and insurance companies) according to the classification adopted by the Department of Company Affairs was 34,367 and 3,711 respectively, as on March 31, 1974, there was a wide gap between the number of companies on the mailing list of the Bank and those registered with the Department of Company Affairs. This gap, in so far as non-financial companies are concerned, could, in a large measure, be attributed to the following factor. Since, in terms of the directions, only such of those non-financial companies as were holding deposits were required to submit the returns/balance sheets to the Reserve Bank, its control could be extended only to those companies which were either voluntarily submitting the returns/balance sheets or those which otherwise came to its notice as receiving deposits. It was stated that except for the information given by the Department of Company Affairs on the basis of the inspections carried out by it or complaints received from the public, DNBC had, till recently, no ready method of finding out whether a non-financial company had failed to comply with its statutory obligations. However, section 45MA of the Reserve Bank of India Act, 1934, as inserted by the Amendment Act, 1974 which came into force with effect from December 13, 1974 now casts an obligation on the statutory auditors to make an enquiry during their audit and report to the Reserve Bank non-compliance in the submission of the returns. The provisions of section 45MA of the Reserve Bank of India Act, 1934 in so far as non-financial companies are concerned, have become in-operative with the withdrawal on June 3, 1975, of the Reserve Bank's directions issued to these companies consequent upon the coming into force of the Companies (Acceptance of Deposits) Rules, 1975 with effect from February 3, 1975. In view of the fact that these companies, irrespective of whether they accept deposits or not, are required to file with the Registrar of Companies their balance sheets, it may be expected that the Department of Company Affairs, with the other data available with it, will be able to ensure that the non-financial companies comply with the statutory obligations in the matter of acceptance of deposits.

7.13 As regards financial companies, the number on the mailing list of

the Reserve Bank is stated to be, only 1,576 as against 3,711 classified as such by the Department of Company Affairs and even out of those identified by the Reserve Bank, only about 800 are submitting the prescribed returns to it. It may be noted that unlike non-financial companies which were required to submit returns only if they held deposits as on March 31 of any year, it is mandatory on the part of financial companies to submit their annual returns and balance sheets to the Reserve Bank irrespective of whether they hold deposits or not. Further, the miscellaneous non-banking companies falling within the purview of the directions issued in August 1973 are required to submit their returns half-yearly. In the circumstances, the variation could be due to either the difference in the mode of classification adopted by the Department of Company Affairs and that by the Reserve Bank or the fact that some of the financial companies, despite their being functioning ones, have failed to submit the prescribed returns. As the gap is sizeable, vigorous steps would have to be taken by the Department to bring all functioning financial companies within the purview of the scheme of control administered by the Reserve Bank by close co-ordination with the Company Law authorities.

7.14 The Department, which was set up in 1966, has so far been in a process of evolution. During its formative stages, certain factors appeared to have operated as constraints on its working. Thus, apart from the limitations in extending the coverage, the directions themselves had to be modified from time to time in the light of the experience gained with a view to plugging the loopholes in the scheme of control. Further, in view of the impending transfer of control over non-financial companies to the Department of Company Affairs, as decided upon a few years back, it could not perhaps make long-term administrative arrangements for fully discharging its functions.

7.15 Certain other factors which impeded the effective enforcement of the directions were also mentioned in this context. It was stated that since the work was practically centralised in Calcutta, it was difficult for the Department to keep a watch over the deposit-acceptance activities of the steadily growing number of NBCs spread over the entire country. Another factor was stated to be the absence of an inspection wing for carrying out inspections on a regular and continuous basis. In terms of the working arrangement with the Department of Company Affairs, the inspection of non-financial companies was to be carried out by the Directorate of Inspection and Investigation of the Department of Company Affairs while that of financial companies was to be undertaken by the Reserve Bank. We understand that DNBC could, however, so far carry out the inspection of only 35 financial companies mainly with the assistance of officers from another department of the Bank. It was also pointed out in this context that until the recent amendments to the Reserve Bank of India Act, 1934, the Bank

had limited powers for taking up inspections; it could carry out inspections only for the purpose of verifying the correctness or completeness of any statement, information or particulars furnished to it or for the purpose of obtaining any information which the companies failed to furnish on being called upon to do so. The Bank has now been empowered to take up the inspection of any financial company if it is considered necessary or expedient to inspect that company.

7.16 We were also given to understand that some of the functions assigned to DNBC when it was initially set up could not, in its formative stages, either be taken up or pursued on a continuous basis. Thus, the Department could not take up a study and analysis of balance sheets of individual companies even on a selective basis for identifying such of the companies as were revealing an unsatisfactory position. Further, in view of the magnitude of the problem involved in scrutinising the returns received from a large number of companies, it could not effectively follow up the non-compliance with the directions by many of these companies nor could it ensure regular submission of returns by the other companies on its mailing list. The delay in scrutiny in turn held up prompt compilation of the data and publication of the annual survey of deposits in the non-banking corporate sector which could also not be made as comprehensive in coverage and scope as originally envisaged. The survey, while presenting informative data, is limited at present to a study of distribution of deposits (including exempted loans) of the reporting companies according to their status (private or public), category (non-financial or different classes of financial companies), the States in which they are located and sources of deposits. It would be useful if the survey could be extended to cover some more aspects such as classification of companies according to their net owned funds and size of deposits, interest-wise break up of deposits and certain facets of the advances portfolio in the case of financial companies.

7.17 In view of the fact that regulation of the acceptance of deposits by non-financial companies has since been transferred to the Department of Company Affairs, the time is now opportune to review the working of DNBC and evolve measures to strengthen the administrative arrangements so that it could effectively concentrate on the areas retained with it for supervision.

ASSESSMENT OF THE FUTURE FUNCTIONS OF DNBC

7.18 The primary function of the Department will hereafter relate to the administration of the scheme of control over the working of the financial companies as envisaged by us. The task set before it will be to achieve the ultimate objectives of the new regulatory measures, viz., to bring these companies within the orbit of a well-integrated and sound financial system

so that the interests of the depositors are protected and their savings, as far as possible, are channelled into productive investment in tune with national priorities. The scope of control, therefore, will not be restricted as hitherto but will be appreciably widened and, to a large extent, akin to that now exercised by the Bank over the banking system. When financial companies not presently on its list are brought within the scheme of control, the number of existing companies (excluding those in liquidation, the conventional chit fund companies and mutual benefit financial companies) may be expected to be about 1,500 to 2,000. However, in the course of administration of the new provisions, many of the companies whose working is not viable or is detrimental to the interests of the depositors or which fail to conform to the new requirements may have to be weeded out. It may be expected that by this process the number of companies would appreciably come down. In the meantime, the Bank may have to prescribe returns to be submitted by the companies at appropriate intervals and make necessary arrangements for scrutinising the returns with a view to watching compliance with the new regulations. It will also have to carry out inspections but it will be sufficient if such inspections are initially conducted on a selective basis, priority being given in respect of the companies with sizeable deposits or against whose working complaints have been received. In the light of the experience gained, the Department may build up an adequate machinery for widening the coverage of inspections of the financial companies in order to ensure that their working is satisfactory and continues to be in conformity with the regulations in force. Considering the scale of operations of such companies as compared with banks having a large number of branches, the task may not be administratively onerous.

7.19 It may be added that since it is proposed to prohibit the acceptance of deposits by unincorporated bodies, it is not unlikely that many individuals/partnership firms now carrying on para banking activities might convert themselves into corporate bodies and would thus come within the ambit of the new regulations. In such an eventuality, the administrative arrangements would have to be further strengthened suitably.

7.20 Apart from its primary function, the Department will be required to perform certain other functions which will be statistical or advisory in nature. Thus, it will have to work in close liaison with the Department of Company Affairs for reviewing the adequacy or otherwise of the regulations governing the activities of companies in the non-banking sector to ensure that the twin objectives of serving as an adjunct to the monetary and credit policy and safeguarding the interests of the depositors are achieved. It will also be required to collect and consolidate the data relating to both financial and non-financial companies although it will no longer be directly concerned in the administration of the scheme of control over the latter. Besides, the Department would have to keep itself in close

touch with the State Governments in regard to the administration of the chit fund and money-lending legislation. A liaison with the State Governments would enable the Reserve Bank to tender advice on policy matters as also amendments to be made as and when deemed necessary.

FUTURE SET-UP OF THE DEPARTMENT

7.21 It appears to us that for an effective implementation of the proposed regulatory measures, it will be necessary to decentralise the functions of the Department so that the impediments now faced under a centralised set-up are removed and in the process, augment the staff at various levels consistent with the workload that may devolve on the central and regional offices. The distribution of financial companies presently on its mailing list would suggest that besides the Regional Cell in Bombay, which may have to be converted into a full-fledged Regional Office, it would be necessary to set up regional offices in Calcutta and Delhi as also one in the Southern Region either in Madras or Bangalore. We understand that a decision in this regard has already been taken by the Bank sometime ago. While the regional offices may be delegated with the functions of supervision over the working of financial companies operating in the area of their jurisdiction and vested with sufficiently wide powers and appropriate status, the overall policy in the matter of administration of the regulatory measures and inspection may be laid down by the Central Office.

7.22 The regional offices may be provided with an inspection wing so that the inspections, at least on a selective basis in the first instance, could be carried out and necessary follow-up action taken expeditiously. Since the nature and scope of such inspections would be different from those of the inspections of banks presently carried out by the Department of Banking Operations and Development of the Bank, it would be necessary to compile a self-contained manual prescribing the guidelines for such inspections. Apart from such regular inspections covering various aspects of the working of financial companies, it would be desirable for the Department to undertake quick inspections covering specific aspects such as verification of the correctness of the information furnished by a financial company, compliance with the provisions regarding maintenance of liquid assets or scrutiny of the complaints alleging irregularities in the working of companies.

ADMINISTRATIVE ARRANGEMENTS IN RESPECT OF NON-FINANCIAL COMPANIES

7.23 In so far as non-financial companies are concerned, the Department of Company Affairs has already a decentralised set-up with Regional Directors in Bombay, Calcutta, Madras and Kanpur and also Registrars of Companies in each State with necessary statutory powers. It has also a Direc-

torate of Inspection and Investigation with regional wings/units to carry out inspection of books of account and records of companies under section 209A of the Companies Act, 1956. We are, therefore, of the view that the additional responsibilities devolving on the Department of Company Affairs may be discharged within the existing administrative framework with such augmentation of staff as may be necessary at the regional levels to cope up with the increased workload involved in the implementation of the provisions of section 58A of the Act and the Rules made thereunder, particularly in the processing of returns and scrutiny of advertisements and in taking follow-up action in respect of defaulting companies.

CO-ORDINATION BETWEEN THE DEPARTMENT OF COMPANY AFFAIRS AND RESERVE BANK

7.24 As stated earlier, the Department of Company Affairs and DNBC would have to work in close liaison for the effective implementation of the objectives. Certain aspects in respect of which consultation and co-ordination would be necessary are indicated in the following paragraphs.

REVIEW OF PROVISIONS RELATING TO ACCEPTANCE OF DEPOSITS, ADVERTISEMENT, ETC.

7.25 Section 58A of the Companies Act provides that the Central Government may, in consultation with the Reserve Bank, make Rules regarding the acceptance of deposits and issue of advertisement by companies. Apart from making such amendments to the Rules applicable to non-financial companies and directions issued by the Reserve Bank to financial companies in the light of our recommendations, it will be desirable that the position is reviewed periodically by the two authorities to ensure evolution of a uniform policy and settlement by mutual consultation of any issues that might crop up.

CLASSIFICATION OF COMPANIES

7.26 We have stated elsewhere that there is a wide gap between the number of financial companies registered with the Company Law authorities and that on the mailing list of the Reserve Bank. While the variation is, to some extent, due to the differing modes of classification, it is apparent that many functioning companies have not been brought within the fold of the existing scheme of control of the Reserve Bank. We understand that in the past, officials of DNBC had been deputed to the offices of some of the Registrars of Companies for bringing the list up to date in an expeditious manner, and that attempts are also being made by it to extend its

control by obtaining a complete list of financial companies from the Company Law authorities. Under the existing arrangements, the periodical additions and deletions to the list are also advised to the Bank. On the basis of the scrutiny of the list, the Bank calls for the Memorandum and Articles of Association and the latest audited balance sheet and, on receipt of the documents, it categorises the financial companies into different classes. For the purpose of keeping its list up to date, it will be necessary for DNBC to evolve a suitable working arrangement in this regard and periodically review the position in consultation with the Department of Company Affairs.

7.27 Another aspect that requires mention is that the norms adopted for classification of financial companies by the two authorities are somewhat different. While the Department of Company Affairs classifies such companies into loan, investment and trust and other financial companies, they are classified by the Reserve Bank into six broad categories depending on the type of business, the returns prescribed varying according to the category in which they are placed. Such detailed classification may cease to be of importance when the exemption available to hire-purchase finance companies from ceiling restrictions is withdrawn and uniform regulatory measures are introduced for financial companies other than chit funds and mutual benefit financial companies. However, for purposes of analysis and interpretation of data, and as the Bank, in the absence of other means, has to depend on the lists furnished by the Department of Company Affairs, it would be useful if the classification is made on a uniform basis. Further, it is observed that a few companies treated by the Company Law authorities as non-financial or financial at the time of their registration on the basis of the principal objects clauses as specified in the Memorandum of Association have been categorised differently by the Reserve Bank on the basis of the pattern of assets and principal sources of income. As this might give rise to conflict of jurisdiction, suitable norms may have to be evolved by the two authorities for classifying companies.

SURVEY OF DEPOSITS IN THE NON-BANKING SECTOR

7.28 As it may be necessary to review from time to time the trend of deposits in the non-banking sector, it would be useful if the two authorities exchange information and also periodically consult each other with a view to reviewing the efficacy of the controls in force and modifications that may be required in the light of the experience gained. Apart from the compilation of the statistical data relating to non-financial companies, it would also be useful if the annual surveys could cover the progress made in enforcing the regulatory measures. As regards financial companies in particular, the surveys may cover the various aspects of their working and implementation of the regulatory measures.

NEED FOR UNDERTAKING RESEARCH ON THE WORKING OF NBFIs

7.29 Finally, we would like to stress the need for research in the important field of NBFIs. In foreign countries, in-depth studies have been made to assess the place of such institutions in the economy, their role in the savings-investment process, the implications of their operations for monetary and credit policy and the relationship between these institutions and the banking system. In India, only *ad hoc* studies relating to NBFIs in general or to particular types of NBFIs have been made. It is necessary to undertake studies on the operations of NBFIs on a continuous basis to provide a solid base for policy formulation. We, therefore, recommend that the Reserve Bank may consider making arrangements for undertaking research on the working of NBFIs and related aspects in the Economic Department of the Bank.

CHAPTER 8

SUMMARY OF MAJOR CONCLUSIONS AND RECOMMENDATIONS

8.1 While giving a summary of our conclusions and recommendations, it is not proposed to restate the full context in which they are made as the analysis and the arguments on which they are based have been fully explained in the preceding chapters. The numbers of the relevant paragraphs of the chapters relating to the conclusions/recommendations have been indicated within brackets to facilitate ready reference.

APPROACH TO THE PROBLEM—QUANTITATIVE AND QUALITATIVE ASPECTS

8.2 There is evidence to show that the dependence of non-financial companies on deposits has tended to increase, and at the same time, the liquidity of these companies in relation to the amount of deposits accepted by them has tended to decline. (2.5)

8.3 Deposits with NBCs have grown in spite of the fact that there are certain advantages attached to commercial bank deposits which are not available in the other case. The basic reason for the growth of deposits of NBCs is that these companies pay interest rates higher than those paid by commercial banks. (2.8)

8.4 The more recent spurt in deposits with NBCs is due to a combination of factors such as the very rapid rise in prices and the consequent decline in the purchasing power of money, aggressive advertising campaign, both by companies and brokers, anti-inflationary measures undertaken by the Government and the Reserve Bank, particularly since the middle of 1974 and the restrictions placed on the declaration of dividends. Although the magnitude of deposits with NBCs in relation to the total bank deposits and other savings media is still limited, there is enough evidence of the acceleration in the growth of these deposits. (2.10 and 2.11)

8.5 While the total level of savings is unlikely to increase on account of the deposits flowing to NBCs, the pattern of savings would undergo a change. There will also be a shift in the ownership of bank deposits from the household sector to the corporate sector. It is likely that over a period the level of deposits of the banking system may remain almost unchanged or may be reduced negligibly by the amount of cash in hand that these companies might wish to keep. The growing volume of deposits with these

companies affects the operation of monetary and credit policy to the extent that it involves loss of direct control on the use of these funds. The current situation, therefore, calls for a regulation but not prohibition of the acceptance of deposits by NBCs. Nevertheless, the long run objective should be to bring about a progressive reduction in the quantum of deposits with non-banking non-financial companies. (2.14 to 2.17)

8.6 A selective approach will have to be taken in regard to the regulation of the activities of NBFCs since these institutions vary greatly in the nature of their operations. In making recommendations on regulating the acceptance of deposits by NBCs, a distinction has to be made between non-banking non-financial companies and NBFCs. The reason is that the latter are para banks whose activities consist of accepting deposits for the purpose of making loans and advances, unlike the manufacturing and trading companies which normally accept deposits for use in their own business. (2.18 and 2.22)

8.7 In regulating deposits with NBCs, it should be ensured that while their magnitude is kept within reasonable limits, they subserve the objectives of monetary and credit policy and that a larger degree of protection is afforded to the depositors' interests. (2.23)

NON-BANKING NON-FINANCIAL COMPANIES

8.8 While arguments advanced for and against the necessity and justification for acceptance of deposits by non-financial companies have merits of their own, the consensus of opinion as put forward before the Group was that the present situation in which there has been a spurt in the soliciting of deposits from the public is an abnormal one brought about by a combination of temporary factors. (4.6)

8.9 The broad approach to the problems posed by public deposits with non-financial companies should be such that measures must be designed to ensure the efficacy of monetary and credit policy and to avoid disruption of the productive process, consistent with the need to safeguard, to the extent possible, the depositors' interests. At the same time, the ultimate objective should be to discourage the further growth of these deposits and to roll them back gradually so that they cease to be significant source of finance for industry and trade. (4.7)

8.10 The Group is not in favour of giving insurance cover to deposits with NBCs on the lines of the cover offered by the Deposit Insurance Corporation in the case of deposits accepted by banks because the risks to be insured would differ widely as between companies and partly because it would be conceptually wrong to confer on unsecured company deposits the same protected status as has been conferred on bank deposits. A degree of risk

is an inevitable concomitant of higher interest rates offered on company deposits. (4.9)

8.11 The *status quo* in respect of the minimum period of deposits (i.e. six months) may be maintained while the maximum duration of deposits should not exceed three years. (4.11 and 4.12)

8.12 The Group is neither in favour of prescribing any ceiling on the rates of interest offered by non-banking non-financial and financial companies on deposits received from the public nor on interest rates chargeable on advances by financial companies. (4.13 to 4.17 and 5.19)

8.13 A lending bank should invariably take into account the quantum of deposits received by the borrowing company while sanctioning/renewing credit facilities to it and also stipulate that the borrowing company should advise the bank about the quantum of deposits proposed to be raised by it. (4.19)

8.14 Non-banking non-financial companies should be required to maintain in the form of liquid assets (excluding cash in hand), a sum which shall not be less than 10 per cent of their deposit liabilities maturing during the course of the year. (4.21)

8.15 The deposits received from directors of all companies as well as from the shareholders of a private company should continue to be exempted so that there are no restrictions on these persons bringing in their own funds and increasing their stake in the business of the company. (4.25)

8.16 The deposits of shareholders of private companies, both non-financial and financial, deemed to be public companies by virtue of section 43A of the Companies Act, 1956, should be given the same treatment as those of shareholders of other private companies. (4.26 and 5.33)

8.17 The Central Government may, by suitably amending the Companies Act, 1956, assume powers to grant extension of time to comply with or exempt any company or class of companies from, all or any of the provisions of the Companies (Acceptance of Deposits) Rules, 1975. (4.27)

8.18 It would not be desirable to withdraw entirely the exemption of inter-company deposits currently available under the Rules. However, the relative provisions in the Rules may be amended to provide that the exemption would be admissible only where the recipient company is a new company, i.e., a company which has not gone into commercial production and it does not also accept any deposits on its own from the public. In other cases, for getting the benefit of exemption the recipient company may be required to obtain the prior approval of the Central Government. (4.28)

8.19 There is no justification for doing away with the exemption in respect of security/dealership deposits which are accepted by manufacturing companies as a traditional business practice. (4.31)

8.20 Convertible debentures/bonds may be exempted from the term 'deposit' under the Rules and the Directions. (4.32 to 4.34 and 5.53)

8.21 The present criterion of relating the quantum of deposits to the net owned funds of a company is by far the most dependable since it is relatively stable in the course of the accounting year of a company and is also administratively feasible. (4.35)

8.22 Notwithstanding the recent reduction of the ceiling in respect of unsecured loans guaranteed by directors, shareholders' deposits, etc., from 25 to 15 per cent of the net owned funds of a company, the Group feels that even the reduced ceiling is somewhat on the liberal side. Hence, the aforesaid ceiling of 15 per cent may be reduced by another 5 per cent with effect from January 1, 1977 and the balance of 10 per cent may also be completely withdrawn with effect from January 1, 1978. (4.37)

8.23 The exemption from the ceiling restrictions avaliable to companies—both non-financial and financial—in respect of deposits secured by the creation of mortgage, charge or pledge of any of their assets is fraught with dangerous consequences and hence, the exemption should be withdrawn. (4.38 to 4.40 and 5.46)

8.24 Besides suggesting certain amendments to the provisions relating to advertisements issued by non-banking non-financial and financial companies, the Group has also recommended furnishing of certain additional particulars in the advertisements/application forms so that the prospective depositors could have a clearer picture of the state of affairs of a company over a period as also the legal implications arising out of keeping deposits with the company. If a private company, whether financial or non-financial, issues any advertisement soliciting deposits, it shall be deemed to be a public company for the purpose of sections 198, 220(1), 372 and 373 of the Companies Act, 1956. (4.41 to 4.43 and 5.41 to 5.43)

NON-BANKING FINANCIAL COMPANIES

8.25 While the magnitude of deposits with NBFCs as compared to the deposits with commercial banks may appear to be small, considering the absolute amount and the large number of depositors involved as well as the incidence of malpractices in these companies, effective regulation of their activities merits careful consideration. NBFCs should be subjected, by and large, to the same type of controls as banks under the Banking Regulation Act, 1949. (5.2 and 5.6)

8.26 In order to decide upon the nature of regulation of NBFCs, the Group has made a distinction between financial companies which are run purely on commercial considerations such as hire-purchase finance, housing finance, investment, loan and miscellaneous financial companies on the one hand and companies which are run for the mutual benefit of the members, viz., companies conducting only conventional types of chits and mutual benefit financial companies (nidhis), on the other. (5.12)

8.27 The extension of insurance cover to deposits with NBFCs is neither feasible nor desirable for the present but can be a long-term objective. Before the question of extending insurance cover to NBFCs is considered, it will have to be ensured that their methods of operation are standardised, weaker units are weeded out by amalgamation or otherwise and their working is generally put on sound footing. (5.17)

8.28 The minimum period for acceptance of deposits by NBFCs may remain at six months as at present. As regards the maximum period, it should be fixed at 3 years in the case of hire-purchase finance, investment, loan, and miscellaneous financial companies and 5 years in the case of housing finance companies. In the case of nidhis, the present position under the directions which do not lay down any minimum or maximum period for acceptance of deposits may be maintained. (5.18)

8.29 Deposits of hire-purchase finance and loan companies should not exceed 10 times their net owned funds. As regards investment companies, the existing ceilings on their deposits should continue for the time being but the ceiling of 15 per cent of the net owned funds in respect of unsecured loans guaranteed by directors, shareholders' deposits, etc., may be reduced by 5 per cent with effect from January 1, 1977 and the balance of 10 per cent may also be completely withdrawn with effect from January 1, 1978. Miscellaneous financial companies may be identified as falling in one or the other of the above categories and the ceilings applicable to them should be determined accordingly. (5.25, 5.28 to 5.30)

8.30 The present exemption in the case of housing finance companies in so far as the ceilings on deposits are concerned may continue. As regards nidhis, moneys received from their members are excluded from the term 'deposit'; as such, the ceilings on deposits are not applicable to them and the *status quo* may be maintained. (5.26 and 5.31)

8.31 The Group has suggested that every NBFC other than a nidhi which commences business after the proposed regulatory measures are brought into force shall have a paid-up capital of not less than Rs 5 lakhs; if such company conducts business only at one place with a population of less than five lakhs, the paid-up capital shall not be less than Rs 2 lakhs. As regards an existing

company other than a nidhi, its net worth (i.e. paid-up capital plus free reserves less balance of accumulated loss and other intangible assets, if any, as appearing in its latest audited balance sheet) shall not be less than Rs 2 lakhs if it conducts its business at only one place with a population of less than five lakhs; in any other case, its net worth shall not be less than Rs 5 lakhs. NBFCs (including nidhis) should be required to transfer to the Reserve Fund a sum equivalent to not less than 20 per cent of their annual profits before declaring any dividend till such time as the amount in the Reserve Fund is less than the paid-up capital of the company. (5.36 and 5.37)

8.32 NBFCs (including nidhis) shall, at all times, maintain liquid assets which shall not be less than 10 per cent of the deposits received by them and outstanding in their books. The Reserve Bank may be authorised to vary the liquid assets ratio of NBFCs in accordance with its monetary and credit policy. (5.39 and 5.40)

8.33 Loans and advances by NBFCs to their directors and firms in which they are interested as partners, managers, etc., should be prohibited. (5.48)

8.34 No NBFC, other than an investment company, but including a nidhi, should be allowed to form any subsidiary, except for the purpose of carrying on the same line of business as that of the holding company. An exception may be made in the case of hire-purchase finance companies. (5.50 and 5.51)

8.35 For the effective regulation of NBFCs, the Reserve Bank should be vested with powers on the lines of certain provisions of the Banking Regulation Act, 1949. (5.54)

8.36 It would be desirable to enact a separate comprehensive legislation in the place of Chapter IIIB of the Reserve Bank of India Act, 1934 for giving effect to the recommendations. Pending enactment of such legislation, the existing provisions of Chapter IIIB *ibid* may be invoked for issuing directions in respect of such of the recommendations as could be implemented. (5.56)

8.37 The Group is of the view that the Reserve Bank of India is the appropriate authority for regulating the activities of NBFCs. (5.59)

MISCELLANEOUS NON-BANKING COMPANIES

8.38 Prize chit/benefit/saving schemes, etc., benefit primarily the promoters and do not serve any social purpose. On the contrary, they are prejudicial to the public interest and also adversely affect the efficacy of fiscal and monetary policy. Such schemes, by whatever name called, should be totally banned in the larger interests of the public and suitable legislative measures should be taken for the purpose if the provisions of the existing enactments are considered inadequate. (6.11)

8.39 As regards conventional chit funds, the Group, while forwarding its comments to the Reserve Bank on the Model Bill drafted by the latter at the

instance of the Central Government, has made certain recommendations, the more important of which are the following:

(1) the Bill should be enacted as a Central Act by Parliament as this step, besides ensuring uniformity in the provisions applicable to chit fund institutions throughout the country, would also prevent such institutions from taking undue advantage either of the absence of any law governing chit funds in any State or exploit the benefit of any lacuna or relaxation in any State Law by extending their activities to such States;

(2) the administration of the proposed legislation should be left to the State Government concerned which, in turn, may seek the advice of the Reserve Bank on policy matters;

(3) private limited companies as also unincorporated bodies, the latter on a restricted scale, may continue to be allowed to run chits; and

(4) chit fund institutions may be prohibited from accepting deposits except as advance payment of subscriptions or deposits from the prized subscribers by way of security towards payment of their future instalments. (6.18)

ADMINISTRATIVE ARRANGEMENTS

8.40 The Department of Non-Banking Companies of the Reserve Bank will have to work in close liaison with the Department of Company Affairs. For an effective implementation of the proposed regulatory measures, DNBC will require to be strengthened and reorganised. For this purpose, it will be necessary to decentralise its functions so that the impediments now faced under a centralised set-up are removed. (7.20 and 7.21)

8.41 The additional responsibilities devolving on the Department of Company Affairs may be discharged within the existing administrative framework with such augmentation of staff as may be necessary at the regional levels to cope up with the increased work-load involved in the implementation of the provisions of section 58A of the Companies Act, 1956 and the Rules made thereunder. (7.23)

8.42 The Reserve Bank may consider making arrangements for undertaking research on a continuous basis on the working of NBFIs and related aspects in the Economic Department of the Bank. (7.29)

J. S. Raj
Chairman
K. B. Chore
V. G. Hegde
A. Hasib
D. M. Sukthankar
R. N. Bansal
V. Subramanian
B. N. Chikarmane
(Member-Secretary)

BOMBAY
July 14, 1975

APPENDICES

APPENDIX I

ORDERS ISSUED BY THE RESERVE BANK OF INDIA CONSTITUTING THE STUDY GROUP, MODIFICATION OF THE TERMS OF REFERENCE, ETC.

RESERVE BANK OF INDIA
DEPARTMENT OF NON-BANKING COMPANIES
CENTRAL OFFICE
15, NETAJI SUBHAS ROAD
POST BOX NO. 571
CALCUTTA-700 001

Ref. No. DNBC. 29/DG(S)-74

June 12, 1974
Jyaistha 22, 1896(S)

The Banking Commission constituted by the Government of India to review, inter alia, "the role of various classes of non-banking financial intermediaries, to enquire into their structure and methods of operations and recommend measures for their orderly growth" made certain recommendations in this regard in its report submitted to Government in January 1972. These recommendations were examined by the Reserve Bank of India and its views thereon were conveyed to Government. The Government have broadly concurred with the views expressed by the Reserve Bank and have, inter alia, decided that the relative provisions of the Reserve Bank of India Act, 1934 and the directions issued to non-banking companies thereunder may be tightened to plug loop-holes, if any, which are being taken advantage of, particularly by private limited companies. With a view to examining this matter in depth, it has been decided to set up a Study Group consisting of the following persons:—

1. Shri James S. Raj, Chairman — Chairman
   Unit Trust of India,
   Bombay.

2. Shri K. B. Chore, — Member
   Joint Chief Officer,
   Department of Banking
   Operations & Development,
   Reserve Bank of India,
   Bombay.

3. Shri V. G. Hegde, — Member
   Joint Legal Adviser,
   Reserve Bank of India,
   Bombay.

4. Shri A. Hasib, — Member
   Director,
   Division of Fiscal Analysis,
   Economic Department,
   Reserve Bank of India,
   Bombay.

5. Shri D. M. Sukthankar, Director, Department of Banking, Ministry of Finance, Government of India, New Delhi. — Member

6. Shri R. N. Bansal, Additional Director of Inspection & Investigation, Department of Company Affairs, Ministry of Law, Justice and Company Affairs, Government of India, New Delhi. — Member

7. Shri B. N. Chikarmane, Assistant Chief Officer, Department of Non-Banking Companies, Reserve Bank of India, Calcutta. — Member-Secretary

2. The terms of reference of the Study Group will be as follows:

I. To examine the relative provisions of the Reserve Bank of India Act, 1934, the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973, with a view to assessing their adequacy in regulating the conduct of business by non-banking companies covered by the said directions in the context of the monetary and credit policies laid down by the Reserve Bank from time to time; to suggest measures for further tightening up the provisions so as to ensure that the activities of such companies, in so far as they pertain to the acceptance of deposits, investments, lending operations, etc. subserve the national interest and serve more effectively as an adjunct to the regulation of the monetary and credit policies of the country besides affording a degree of protection to the depositors' monies. In this connection, the Study Group may examine and make recommendations for regulating the conduct of the business of non-banking companies governed by the above sets of directions generally, and in particular, in regard to—

(a) the norms which may be adopted in respect of the capital structure and debt-equity ratio that may be maintained by the various classes of non-banking companies covered by the said directions;

(b) the extent to which and the periods for which such companies may borrow by way of deposits/unsecured loans and the distinctions, if any, to be made between public and private limited companies for this purpose;

(c) the maintenance of cash reserves and/or a percentage of their deposit liabilities in the form of liquid assets by such companies;

(d) the norms which may be adopted in respect of the rates of interest payable by such companies on their borrowings by way of deposits/unsecured loans and also those which may be charged on loans and advances made by them;

(e) the extent to which any of the activities carried on by these companies through their subsidiaries can or should be controlled;

(f) the need for the imposition of a ceiling on risk assets to be acquired or loans to be granted by the companies;

(g) the restrictions, if any, on the grant of loans to directors and their friends and relations and companies in which they are interested;

(h) the manner in which the loop-holes, if any, in the existing directions taken advantage of by private limited companies in the context of certain concessions enjoyed by such companies under the provisions of the Companies Act, 1956 could be plugged; and

(i) need to empower the Bank to apply for compulsory winding up of non-banking financial companies under certain circumstances.

II. To make recommendations on any other related topic which the Study Group may consider germane to the subject matter of the enquiry.

Sd/-
(S. S. SHIRALKAR)
DEPUTY GOVERNOR

RESERVE BANK OF INDIA
DEPARTMENT OF NON-BANKING COMPANIES
CENTRAL OFFICE
15, NETAJI SUBHAS ROAD
POST BOX NO. 571
CALCUTTA-700 001

Ref. No. DNBC. 30/DG(S)-74

June 17, 1974
Jyaistha 27, 1896(S)

In partial modification of the order No. DNBC. 29/DG(S)-74 dated the 12th June 1974, it has been decided that Shri D. D. Bhargava, Chief Officer, Department of Non-Banking Companies, Reserve Bank of India, Calcutta, should also be a member of the Study Group.

Sd/-
(S. S. SHIRALKAR)
DEPUTY GOVERNOR

RESERVE BANK OF INDIA
DEPARTMENT OF NON-BANKING COMPANIES
CENTRAL OFFICE
15, NETAJI SUBHAS ROAD
POST BOX NO. 571
CALCUTTA-700 001

Ref. No. DNBC. 31/DG(S)-74

September 4, 1974
Bhadra 13, 1896(Saka)

In partial modification of the order No. DNBC. 29/DG(S)-74 dated the 12th June 1974, it has been decided that the Study Group shall also examine the relative provisions of the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966; all references to non-banking companies covered by the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 referred to in paragraph 2 of the said order shall also be deemed to refer to Companies covered by the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966.

Sd/-
(S. S. SHIRALKAR)
DEPUTY GOVERNOR

RESERVE BANK OF INDIA
DEPARTMENT OF NON-BANKING COMPANIES
CENTRAL OFFICE
15, NETAJI SUBHAS ROAD
POST BOX NO. 571
CALCUTTA-700 001

Ref. No. DNBC. 35/DG(S)-75

January 30, 1975
Magha, 10, 1896(Saka)

In partial modification of the order No. DNBC. 30/DG(S)-74 dated the 17th June 1974 and consequent on his appointment as the Chief Officer, Department of Non-Banking Companies, Reserve Bank of India, Calcutta, Shri V. Subramanian is hereby appointed as a member of the Study Group on Non-Banking Companies *vice* Shri D. D. Bhargava, transferred to the Department of Banking Operations and Development, Calcutta.

Sd/-
(S. S. SHIRALKAR)
DEPUTY GOVERNOR

APPENDIX II

SPECIFIC POINTS OF THE TERMS OF REFERENCE OF THE STUDY GROUP, ON WHICH THE DETAILED MEMORANDA WERE CALLED FOR FROM CERTAIN BANKERS, REPRESENTATIVES OF TRADE, INDUSTRY AND COMMERCIAL ORGANISATIONS, ETC.

1. Effect of acceptance of deposits by non-banking companies on savings, pattern of savings, investments and pattern of investments.

2. Whether the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 read with the provisions of the Amending Bill are adequate for the purpose of regulating the deposit-acceptance activities of non-banking companies from the point of view of effectively serving as an adjunct to monetary and credit policy of the country besides affording a degree of protection to the depositors' funds. Specific respects in which the provisions of the Act could be further amended for fulfilling the objectives in view.

3. Whether the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 and the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 issued by the Bank fulfil the objectives referred to in the preceding item. Specific respects in which these may be further amended.

4. Specific suggestions for regulating the conduct of business of non-banking financial and miscellaneous non-banking companies covered by the relative sets of directions.

5. Suggestions regarding the norms which may be prescribed in respect of the capital structure and debt-equity ratio for the various classes of non-banking companies covered by the three sets of directions.

6. Paragraph 2(1)(f) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 and paragraph 3(1)(d) of the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 exclude certain categories of monies accepted by the types of companies concerned from the purview of the term 'deposit' as defined in the said directions. Suggestions for adding to or deleting from, the categories of exempted deposits referred to in the said paragraphs.

7. Loans secured in the manner specified in the first proviso to paragraph 3(1)(d) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, paragraph 3(2) of the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 and paragraph 4 of the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 are not considered as 'deposits' for the purpose of the ceiling restrictions prescribed under the said paragraphs. Is this exemption necessary or desirable from the point of view of the objectives referred to in item 2 above?

8. Suggestions regarding the extent to which and the periods for which non-banking companies may borrow by way of deposits and/or unsecured loans [viz., those received from members (not being deposits received by a private limited company from its members under a specified type of declaration), unsecured debentures, deposits guaranteed by directors in their indivi-

dual capacity and unsecured loans guaranteed by the former managing agents or secretaries and treasurers] and the distinctions which may be made between public and private limited companies for this purpose. Would it be desirable to combine the ceilings prescribed in respect of the two categories of deposits referred to above into one?

9. Norms which may be prescribed in respect of maintenance of cash reserves and/or of a percentage of deposit liabilities in the form of liquid assets by such companies.

10. Norms which may be prescribed in respect of the rates of interest payable by non-banking companies on their borrowings by way of deposits and/or unsecured loans and also those which may be charged on loans and advances made by non-banking financial and miscellaneous non-banking companies.

11. Suggestions regarding the extent to which any of the activities carried on by non-banking companies through their subsidiaries can or should be controlled.

12. Suggestions for regulating the utilisation of funds borrowed by non-banking companies by way of deposits.

13. Suggestions, if any, for improving the quality of advances made by non-banking financial and miscellaneous non-banking companies and recovery-performance of the advances.

14. The need, if any, for imposition of a ceiling on the risk assets to be held or on the loans granted by non-banking financial and miscellaneous non-banking companies.

15. In the context of certain concessions enjoyed by private limited companies under the provisions of the Companies Act, 1956, do you feel that there are any loopholes in the Reserve Bank of India Act or in the three sets of directions referred to in item 3 above which are being taken advantage of by the companies covered by the said directions and which require to be plugged?

16. Whether there is any need for empowering the Reserve Bank of India to apply to an appropriate Court for the compulsory winding up of a non-banking financial company or a miscellaneous non-banking company. If so, the circumstances in which the Bank may be empowered to approach the Court for the purpose.

17. Suggestion(s) on any other relevant topic which is considered germane to the subject-matter of the enquiry presently being conducted by the Study Group.

APPENDIX III

LIST OF INDIVIDUALS/COMPANIES/ASSOCIATIONS/INSTITUTIONS ETC. WHO SUBMITTED MEMORANDA ON THE VARIOUS ASPECTS RELATING TO THE WORK OF THE STUDY GROUP

I. BANKS

1. Bank of Baroda, Bombay
2. Canara Bank, Bangalore
3. Federal Bank Ltd., Alwaye
4. Indian Bank, Madras
5. Indian Overseas Bank, Madras
6. State Bank of Mysore, Bangalore
7. United Commercial Bank, Calcutta

II. INDIAN BANKS ASSOCIATION, BOMBAY

III. INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA, NEW DELHI

IV. CHIT FUNDS/FINANCE CORPORATIONS

1. Coimbatore South Indian Chit Funds Ltd., Coimbatore
2. Jupiter Chit Fund Pvt. Ltd., Kanpur
3. Karnataka Finance Corporation, Bangalore
4. Margadarsi Chit Fund Pvt. Ltd., Hyderabad
5. Mayavaram Financial Corporation Ltd., Mayavaram
6. Triplicane Permanent Fund Ltd., Madras

V. ASSOCIATIONS OF CHIT FUNDS/NIDHIS

1. Associated Body of Nidhis, Madras
2. Incorporated Chit Fund Companies Association, Mayavaram
3. Kuri Foreman's Association, Trichur
4. Tamilnad Chit Fund Companies Association, Tirunelveli

VI. COMPANIES

1. Associated Traders & Engineers Pvt. Ltd., New Delhi
2. Bajaj Capital Investment Centre (P) Ltd., New Delhi
3. Dalal Engineering Pvt. Ltd., Bombay
4. Hind Finance, Industries and Investment Ltd., Nagpur

VII. CHAMBER OF COMMERCE AND INDUSTRY, ASSOCIATIONS ETC.

1. Ahmedabad Mill Owners' Association, Ahmedabad
2. Association of Investors in Non-Banking Companies, Bangalore
3. Cochin Chamber of Commerce & Industry, Cochin
4. Federation of Andhra Pradesh Chambers of Commerce & Industry, Hyderabad
5. Federation of Indian Chamber of Commerce & Industry, New Delhi
6. Federation of Karnataka Chamber of Commerce & Industry, Bangalore
7. Indian Merchants' Chamber, Bombay
8. Mahratta Chamber of Commerce & Industries, Poona
9. Market Research & Development Council, Bombay

10. Mill Owners' Association, Bombay
11. Native Residents' Association of Madras City, Madras
12. Punjab & Haryana Finance Companies Association, Jullundur City
13. Southern India Chamber of Commerce & Industry, Madras
14. Southern India Mill Owners' Association, Coimbatore

VIII. INDIVIDUALS

1. Shri Bipin S. Acharya, Ahmedabad
2. Shri K. M. Balavenkataraman, Manager, Salem Sree Ramavilas Company Private Ltd., Salem
3. Shri A. R. Bhat, Poona
4. Shri R. S. Bhatt, Chairman, India Investment Centre, New Delhi
5. Shri M. R. Bhide, Executive Chairman, Voltas Ltd., Bombay
6. Shri S. Bhoothalingam, Director, National Council of Applied Economic Research, New Delhi
7. Shri A. B. Bilimoria, Director-in-charge, Tata Consultancy Services, Bombay
8. Shri K. S. Chakrapani, Chief Officer, Department of Banking Operations & Development, Reserve Bank of India, Bombay
9. Shri Damodarlal Daga, Calcutta
10. Dr. L. C. Gupta, c/o Xavier Labour Relations Institute, Jamshedpur
11. Shri D. R. Joshi, Executive Director, M. Visvesvaraya Industrial Research and Development Centre, Bombay
12. Shri A. R. Khare, Joint Regional Director, Company Law Board, Bombay
13. Shri R. Satyanarayan Kulur, Calicut
14. Shri T. V. Narayana Marar, Bangalore
15. Dr. C. P. S. Nayar, Bombay
16. Dr. T. M. A. Pai, Manipal
17. Dr. V. K. R. V. Rao, Director, Institute for Social and Economic Change, Bangalore
18. Shri R. G. Saraiya, Bombay
19. Dr. M. Saravane, Research Officer, Division of Fiscal Analysis, Economic Department, Reserve Bank of India, Bombay
20. Shri Narottam Shah, Commerce Research Bureau, Bombay
21. Shri N. K. Thingalaya, Economist, Syndicate Bank, Manipal
22. Shri Parmanand Uttamchand, c/o Ochiram Parmanand, Shroffs, Madras
23. Shri M. G. Varughese, Member, A.I.C.C., Gujarat

APPENDIX IV

LIST OF INDIVIDUALS/COMPANIES/ASSOCIATIONS/INSTITUTIONS ETC. WITH WHOM THE MEMBERS OF THE STUDY GROUP HAD DISCUSSIONS ON THE VARIOUS ASPECTS RELATING TO THE WORK OF THE STUDY GROUP

(arranged in the chronological order of meeting them)

I. AHMEDABAD

1. Shri Pannalal Jhaveri, Hon. Secretary, Gujarat Sadachar Samiti, Ahmedabad.
2. Shri K. D. Budha, Registrar of Co-operative Societies, Gujarat.
3. Shri S. R. Bastikar, Secretary and Financial Controller, Ahmedabad Manufacturing & Calico Printing Co. Ltd., Ahmedabad.
4. Shri Niranjan Vyas, Assistant Secretary, Gujarat State Congress (R) Committee.
5. Ahmedabad Mill Owners' Association.
6. Shri Bipin S. Acharya.
7. Shri M. G. Varughese, Member, A.I.C.C., Gujarat.
8. Shri J. G. Gatha, Registrar of Companies, Gujarat.
9. Shri J. M. Thakkar, Chartered Accountant, Ahmedabad.
10. Shri S. S. Sahani, Chief General Manager, State Bank of India, L.H.O., Ahmedabad.
11. Shri H. S. Majumdar, Managing Director, State Bank of Saurashtra, Bhavnagar.

II. NEW DELHI

12. Shri P. L. Tandon, Chairman & Managing Director, Punjab National Bank, New Delhi.
13. Shri S. Ratnam, Controller, Delhi Cloth & General Mills Ltd., New Delhi.
14. Shri S. Bhoothalingam, Director, National Council of Applied Economic Research, New Delhi.
15. Shri A. K. Sen Gupta, Dean, Institute of Chartered Accountants of India, New Delhi.
16. Shri S. Kumar, Registrar of Companies, Delhi & Haryana.
17. Bharat Bhushan & Co., Share-brokers, New Delhi.
18. Shri T. C. Mitla, Oriental Bank of Commerce Ltd., New Delhi.
19. Shri K. K. Bajaj, Managing Director, Bajaj Capital Investment Centre (P) Ltd., New Delhi.

19A. Shri D. N. Ghosh, Joint Secretary, Department of Banking, Ministry of Finance, Government of India, New Delhi.

III. CALCUTTA

20. Prof. Kshitimohan Mukherji, Dean, Faculty of Commerce, Calcutta University, Calcutta.
21. Shri P. K. Sen, General Manager, United Bank of India, Calcutta.
22. Shri B. K. Puri, Group Chief Accountant, Macneill Barry & Co. Ltd., Calcutta.
23. Dr. Alok Ghosh, Calcutta University, Calcutta.
24. Dr. Bhabatosh Datta, Director, Reserve Bank of India.

25. Shri Damodarlal Daga, Calcutta.
26. Shri R. C. Maheshwari, General Manager, Texmaco, Calcutta.
27. Shri A. K. Ganguly, Editor, The Capital, Calcutta.
28. Prof. J. K. Sen Gupta, Director, Indian Institute of Management, Calcutta.
29. Bengal Chamber of Commerce & Indusry, Calcutta.
30. Bengal National Chamber of Commerce & Industry, Calcutta.
31. Indian Chamber of Commerce, Calcutta.
32. Jupiter Chit Fund (P) Ltd., Kanpur.
33. Shri H. K. Mohta, Director, Gem Savings Unit Pvt. Ltd., Calcutta.
34. Shri V. R. Desai, Chairman & Managing Director, United Commercial Bank, Calcutta.

IV. BANGALORE

35. Federation of Finance Corporations, Bangalore.
36. Federation of Karnataka Chamber of Commerce & Industry.
37. Shri H. N. Rao, General Manager, Syndicate Bank, Manipal.
38. Shri C. S. Hubli, Deputy Secretary, Development, Housing, Panchayat Raj & Co-operation Department, Government of Karnataka, Bangalore.
39. Shri C. E. Kamath, Chairman & Managing Director, Canara Bank, Bangalore.
40. Shri K. N. Subramaniam, Editor, Southern Economist, Bangalore.
41. Shri N. D. Ramanan, Planning Manager, State Bank of Mysore, Bangalore.
42. Shri M. P. Prabhu, Managing Partner, Karnataka Finance Corporation, Bangalore.
43. Shri V. Srinivasan, President, Association of Investors in Non-Banking Companies, Bangalore.

V. COCHIN

44. Cochin Chamber of Commerce & Industry, Cochin.
45. Kuri Foremen's Association, Trichur.
46. Shri R. S. Kalur, Calicut.
47. Shri P. V. Unnikrishnan, Secretary, Kerala State Financial Enterprises Ltd., Trichur.
48. Shri K. P. Cherian.
49. The Southern India Mill Owners' Association, Coimbatore.
50. Shri Anwar, Registrar of Companies, Kerala.

VI. MADRAS

51. Southern India Chamber of Commerce, Madras.
52. Shri L. Krishnan, Chairman, Bank of Madura Ltd., Madurai.
53. Shri S. V. Sundaram, General Manager, Indian Overseas Bank, Madras.
54. Shri K. P. Hormis, Chairman, Federal Bank Ltd., Alwaye.
55. Shri R. R. Dalavai, Secretary, Native Residents' Association of Madras City, Madras.
56. Shri A. G. Sirsi, Registrar of Companies, Tamil Nadu.
57. Shri D. F. Kantharaj, Deputy Secretary to the State Government of Tamil Nadu, Revenue Department, Madras.
58. Shri T. S. Santhanam, Chairman, Sundaram Finance Ltd., Madras.
59. Shri K. Venkatrama Iyer, General Manager, Indian Bank, Madras.
60. Associated Body of Nidhis, Madras.
61. Egmore Benefit Society Ltd., Madras.
62. Triplicane Permanent Fund Ltd., Madras.
63. Mylapore Hindu Permanent Fund Ltd., Madras.

64. Tamil Nadu Chit Fund Companies Association, Tirunelveli.
65. Incorporated Chit Fund Companies Association, Mayavaram.

VII. **BOMBAY**

66. Shri M. R. Bhide, Executive Chairman, Voltas Ltd., Bombay.
67. Bombay Chamber of Commerce and Industry.
68. Shri M. P. Chitale, Director, Reserve Bank of India.
69. The Mill Owners' Association, Bombay.
70. Maharashtra Chamber of Commerce.
71. Shri A. R. Khare, Joint Director, Company Law Board, Bombay.
72. Institute of Chartered Accountants of India.
73. Shri V. M. Bhide, Chairman and Managing Director, Bank of Maharashtra, Poona.
74. Indian Merchants' Chamber, Bombay.
75. Indian Banks Association, Bombay.
76. All India Manufacturers Organisation, Bombay.
77. Shri S. Jagannathan, Governor, Reserve Bank of India, Bombay.
78. Dr. R. K. Hazari, Deputy Governor, Reserve Bank of India, Bombay.
79. Shri S. S. Shiralkar, Deputy Governor, Reserve Bank of India, Bombay.
80. Shri R. K. Seshadri, Deputy Governor, Reserve Bank of India, Bombay.
81. Dr. K. S. Krishnaswamy, Executive Director, Reserve Bank of India, Bombay.

APPENDIX V

REGULATION OF THE ACTIVITIES OF NON-BANKING FINANCIAL INTERMEDIARIES (NBFIs) IN SELECTED COUNTRIES

A summary of the important statutory provisions regulating the activities of Non-Banking Financial Intermediaries in twelve foreign countries is given below:

AUSTRALIA

The Australian Financial system includes a wide range of financial intermediaries. The non-banking financial intermediaries include building societies, unit trusts, life assurance offices, pastoral finance companies, instalment credit companies, development finance institutions (including merchant banking-type companies) and credit unions.

The Financial Corporations Act, 1974 requires a wide range of financial corporations whose assets exceed $ 1 Million to register with the Reserve Bank and to provide certain information about their activities. These Non-Banking Financial Institutions whose assets exceed $ 5 Million are subject to regulation of assets ratios, lending, and interest rates. The collection of information from NBFIs is a policy objective in Australia so that the regulations can be tailored to suit the requirements of particular types of financial institutions. Stress is also given to the need for consulting NBFIs and seeking their co-operation for voluntary restraint.

There is also, at the State level, money-lending legislation which imposes conditions on the activities of money-lenders including the form in which they may advertise for public deposits.

CANADA

In Canada, there are institutions other than banks which accept deposits from and make loans to the public. Some of these institutions such as trust companies, loan companies, money-lenders and credit unions operate under certain special federal or provincial government laws. Others, such as finance and investment companies are incorporated under the general federal or provincial company legislation. The deposits with all the provincial trust and loan companies are insured with the Canada Deposit Insurance Corporation—a federal institution with regulatory powers.

A loan company in Canada may accept deposits but the amount so held should not exceed the aggregate amount of its paid-up and unimpaired capital stock and of its cash actually in hand or deposited in any Chartered Bank in Canada. The auditor of a loan company has to submit annual reports to the Superintendent, Department of Insurance. The investments of a loan company (receiving deposit or borrowing money) in common shares of capital stock shall not exceed 25 per cent of the company's total funds. Granting of loans to a director or officer of the company or to a spouse or child of a director or to a Corporation in which a director is interested is prohibited. A loan company has to maintain 20 per cent of the deposits in liquid assets or in fully secured loans repayable on demand. The value of real estate required for its actual use and reasonably required for natural expansion of its business should not exceed 35 per cent of the company's unimpaired capital, surplus and reserves.

Small loan companies are covered by the Small Loans Act. They are authorised to lend money on promissory notes or other personal security and on chattel mortgages but are not allowed to accept money on deposit.

A trust company may receive money on deposit and allow interest thereon at such

rate as agreed upon and also advance moneys to protect any estate, trust or property entrusted to it; it has to maintain at all times, reserves at an aggregate of at least 25 per cent of the amount of funds received for guaranteed investment repayable on demand or becoming due in less than one hundred days. It can borrow upon the credit of the company or against the hypothecation, pledge or mortgage of its property on the authority of its General Body meeting by a resolution passed by sharehoders holding 2/3rds of its share capital, but only up to 12½ times the excess of the assets of the company over its liabilities. A trust company cannot, however, borrow by issue of bonds or debentures.

FRANCE

The jurisdiction of the National Credit Council which is entrusted with the enforcement of the regulation of banking has been extended to two categories, viz., banks and financial institutions. Institutions other than banks cannot accept public deposits repayable on demand or on notice for less than two years. Financial institutions have been defined as enterprises which, without receiving public funds, carry out one or several of the following operations:—

(i) Effect short or medium-term credit operations and exchange operations;
(ii) Discount, take as security or collect bills of exchange, cheques and public securities;
(iii) Serve as commission agents, brokers or intermediaries in the operations concerning securities and funds of the State, bills of exchange and public securities.

As in the case of banks, these institutions are also required to be registered with the National Credit Council and to maintain a minimum amount of paid-up capital as prescribed by the law. The financial institutions are not classified into legal categories. However, the National Credit Council imposes upon them a de facto specialisation in strictly limiting their activities to specific types of operations which the institutions declare in their application for registration. This specialisation permits categorisation of financial institutions under the following heads:

(i) Group finance companies,
(ii) Houses of securities,
(iii) Houses for financing hire purchase,
(iv) Loan societies or real estate societies,
(v) Societies for lease (movable or immovable property),
(vi) Miller Unions, and
(vii) Miscellaneous.

The Commission of Control of Banks in France may strike out the name of a company from the list for non-adherance to the advices issued by the Commission.

JAPAN

In a broader sense, NBFIs in Japan include financial institutions i.e. mutual loan and savings banks, credit associations, credit co-operatives and financial institutions for agriculture, in addition to the insurance companies and government institutions including financial agencies and the postal savings system. Monetary policy in Japan was traditionally centred on commercial banks, especially city banks. However, certain monetary measures have recently been extended to NBFIs. The reserve deposit requirements which were limited only to banks have since 1963 been extended to mutual loan and savings banks and credit associations holding deposits of over 20 billion. In 1969, the Central Co-operative Bank for Agriculture and Forestry

was also brought under control. Later, with a revision of the law in 1972, the reserve requirement was made applicable also to life insurance companies, where necessary. Thus, the scope of the monetary policy of the Bank of Japan has been extended from time to time to cover various categories of financial institutions as changing conditions and the monetary environment demanded. So far as the supervision of NBFIs is concerned, it is the responsibility of the Ministry of Finance. In practice, however, NBFIs and specialised financial institutions, are placed under the guidance and supervision of different Government agencies and the Bank of Japan carries out the supervisory examination of these institutions on its own.

MALAYSIA

The provisions of the Borrowing Companies Act, 1969 regulate the activities of non-banking financial intermediaries in Malaysia. The term 'borrowing business' has been defined to mean acceptance of any money on deposit or loan by a person from more than ten persons wherein the borrower is under a liability to repay the money to those persons and is subjected to restriction on the lending or investment of such funds. Subject to the provisions of the above Act and notwithstanding the provisions of the Companies Act, 1965, no person shall carry on borrowing business unless it is (a) a public company (b) a licensed borrowing company; a licensed borrowing company shall not carry on any kind of business other than borrowing business. Only public companies with a paid-up capital of Malaysian $10,00,000 (about Rs 34 lakhs) can get a licence from the Central Bank of Malaysia. The licensed borrowing companies may accept deposits or loans for such minimum period as may be prescribed by the Central Bank from time to time and such deposits should not be repayable on demand by cheque. The Central Bank is empowered to make rules prescribing the rates of interest to be allowed by Non-Banking Companies on public deposits. The borrowing companies are required to maintain a reserve fund. Restrictions on payment of dividend are also provided for in the Act. Besides maintenance of a minimum amount of liquid assets, as prescribed by the Central Bank from time to time, no licensed borrowing company shall hold risk assets (i.e. assets other than liquid assets and the reserve held with the Central Bank) in excess of ten times of its paid-up capital and reserves. Unsecured loans in excess of Malaysian $5,000 (about Rs 17,000) to any person and granting of loans to directors have been prohibited. Hire-purchase loans are required to be granted in accordance with the provisions of the Hire Purchase Act, 1967, a law mainly designed to protect the rights of consumers. Certain restrictions on the types of investments which could be made by a licensed borrowing company have also been laid down. No licensed borrowing company in Malaysia may acquire (1) shares in any corporation, (2) immovable property, or (3) any beneficial interest in any firm except with the consent of the Central Bank. Monthly returns in respect of loans/other credit facilities have to be submitted to the Central Bank and if it appears to that Bank that any advances are being granted to the detriment of the interests of the depositors, the bank may prohibit the company from making further advances/impose restrictions on grant of advances/secure repayment of the advances within such time and to such extent as may be directed. Licensed borrowing companies are inspected by the Central Bank from time to time. The Central Bank may file a petition in the High Court for winding up of a borrowing company if the company is likely to fail to meet its obligations or is carrying on its business in a manner detrimental to the interests of its depositors. Under certain circumstances, it may assume control of and carry on the business of a licensed borrowing company or appoint a person to advise the licensed borrowing company in the proper conduct of its business.

NEW ZEALAND

The powers of the Reserve Bank of New Zealand to exercise control over non-banking financial intermediaries have been considerably strengthened with the passing

of the Reserve Bank (Amendment) Act, 1973. One of the main objectives of this legislation was to bring all financial institutions within the sphere of monetary policy and thus enable the Bank to exercise uniform supervision over both banking and non-banking financial institutions. Since the coming into force of this legislation, it is stated that there has been a better co-ordination of policy; closer contact has been made with the various sections of the financial market and working relations with the various groups of institutions have been improved.

Under the 'voluntary' investment arrangement, every finance company has to hold Government stock to the extent of 10 per cent of its borrowings.

The Interest on Deposit Regulations specify maximum deposit rates for various terms for deposit-taking institutions. The Government may also require financial institutions to hold specified assets. The Bank has the authority to require information from any financial institutions as to the assets and liabilities of its business. The power of the Reserve Bank to inspect the books of account and other records of trading banks has been extended to apply to other financial institutions. The Reserve Bank may make recommendations or give directives to any class of financial institutions in respect of their business; it may also give directions as to the policy to be followed in relation to lending and investments.

Under the Money-lenders' Act, 1908, every money-lender is required to be registered with the concerned authority and obtain annual licence. Money-lending advertisements and payment of compound interest by the money-lenders are prohibited.

NETHERLANDS

The problem of regulating the activities of 'nearbanking' institutions functioning in the country has necessitated the Government to draft a Bill for amending the Supervision of the Credit System Act, 1952. When the Bill is enacted, it is expected to bring the near-banking institutions under 'social-economic', i.e. monetary supervision. Each credit institution shall have to maintain a minimum amount of capital as provided for in the proposed law. Companies not being credit institutions will be prohibited from accepting monies withdrawable on demand or at a notice of two years or less, unless certain requirements pertaining to resources, control and publication of the annual statement of accounts have been fulfilled. The regulations will provide for issue of directions regarding the maximum amount of all or any lending and investment. The proposed amendments will also empower the Netherlands Bank to file a petition with the court for a 'receiving order' if the institution is unable to pay its debts.

PHILIPPINES

The investment houses, i.e., enterprises which are engaged in underwriting of securities of other corporations are subject to the provisions of the Investment Houses Law. These Houses cannot engage in banking operations.

The Central Bank Act provides that the financial institutions should maintain reserves against their deposit liabilities. The Monetary Board may also fix the maximum rates of interest which other financial institutions may pay on deposits.

SWITZERLAND

The problems arising out of acceptance of deposits by non-banking companies necessitated a revision of the Swiss Banking Law in 1971. The controlled activity now covers all industrial, commercial and finance companies which appear on the public capital market with a view to accepting deposits from other companies or persons. With the exception of Investment Funds which are regulated by the Federal Law on Investment Funds of 1966, all other financial institutions (including banks) are being

controlled by the Federal Law on Banks and Savings Banks of 1934, the provisions of which extend to financial institutions and individual firms of 'banking nature'. Non-Banking institutions cannot accept savings deposits. Advertisements soliciting/inviting deposits may be issued only in accordance with the rules prescribed by the concerned authorities in this behalf. The ceiling and margin on loans are fixed by law. Deposits cannot be invested except in Government securities and in immovable properties. More than 7½ per cent of the investible funds cannot also be invested in one firm. There should be a proportion between owned funds and total liabilities. The minimum paid-up capital has been fixed for each institution at 2m. francs (about Rs 37.91 lakhs). The Commission of Banks which is the main authority of supervision can depute an expert in the capacity of an observer to a financial institution (including a bank) whose creditors seem to be seriously threatened by grave and persistent irregularities. This observer watches the activities of the institution and, in particular, the execution of the measures imposed by the Commission of Banks. The authorities can dissolve an investment company, if necessary. An improvement of the relationship between the institution of audit and the authority of supervision has contributed to a quicker communication of the irregularities to the latter; this enables the authorities to intervene sufficiently in advance. If the auditors discover, during the course of their audit, contraventions of the legal provisions or other irregularities, the financial institutions are asked to take corrective action within certain stipulated time. In case of failure to do so, the matter is referred to the Commission of Banks. Grave irregularities observed during the course of audit are, however, immediately brought to the notice of the Commission.

UNITED STATES OF AMERICA

There are two major federal regulatory agencies, viz., The Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation which supervise many of the nation's savings and loan associations and mutual savings banks. The members of the Federal Home Loan Bank Board are Building and Loan Associations, Savings and Loan Associations, Co-operative Banks, Homestead Associations, Insurance Companies or Savings Banks.

The main business of mutual savings banks is collecting and channelling savings of small investors into mortgages and other types of loans, Government Bonds, etc. They do not generally accept demand deposits and hence, cannot conduct many ordinary commercial banking operations. Most States permit mutual savings banks to invest only in an approved list of securities prepared by the State legislature or the State agency supervising the banks.

Sales finance companies are active in the field of direct consumer lending and many consumer finance companies are expanding into consumer durables and commercial financing. In a number of States, sales finance companies are regulated by State laws governing instalment selling. State laws usually regulate insurance coverage, terms of rebate, finance charges, and the like and provide that the written contract must set forth the terms of agreement. Consumer finance companies operate under State small loan laws which set minimum capitalisation for companies and specify the necessary records, essential forms, permissible rates, loan limits, etc.

Rates of interest, commission, etc. to be charged are subject to certain restrictions under the Home Loan Bank Act. Each member is required to maintain liquid assets which may not be less than 4 per cent or more than 10 per cent of its obligations on withdrawable accounts and borrowings repayable on demand. The payment and advertisement of interest or dividend on deposits, shares, etc. are also subject to the rules prescribed by the authority. The minimum capital of each Federal Home Loan Bank shall not be less than the amount prescribed and they have to carry to a 'Reserve' account every half-year an amount equal to 20 per cent of its net earnings until the 'Reserve' account is equal to paid-up capital and thereafter 5 per cent. The Federal Home Loan Bank Board supervises the activities of the Federal Home Loan Banks.

Investment companies which are governed by the Investment Company Act of 1940 are required to be registered with the 'Securities and Exchange Commission'. They are prohibited from making any transactions in the nature of trading in securities and the Act prescribes the maximum amount which can be invested in a particular company or in a company in the same group. Substitution of the holdings is subject to the prior approval of the Commission. Payment of dividend from any source other than from the company's undistributed income is prohibited.

UNITED KINGDOM

The Protection of Depositors' Act, 1963 regulates the issue of advertisements soliciting deposits, makes special provision with respect to the accounts to be delivered by and the supervision of companies which issue such advertisements. Fraudulent inducements of persons by false promises or forecast or by dishonest concealment of material facts or by reckless making of any misleading, false or deceptive statements are liable on conviction, to imprisonment or fine or both. The Board of Trade may make regulations prescribing the matters which must or must not be included in any such advertisement. Before issuing any advertisement for deposits, a company has to deliver to the Registrar of Companies and the Board of Trade a balance-sheet and profit and loss account in regard to the accounting period as prescribed in the Act. The authorities may require finance companies to produce their books, etc. If a private company issues advertisement soliciting deposits, the company shall not be deemed to be a private company for certain provisions of the Companies Act, 1948 (of the U.K.), the most important of which is the prohibition of granting loans to directors. The Court may, on a petition presented by the Board of Trade, wind up any company under the Companies Act, 1948, if it is unable to pay its depositors or if the value of the company's assets is less than the amount of its liabilities or it has defaulted in complying with any requirement of the Act in so far as it relates to the delivery of accounts.

WEST GERMANY

The main concern of the authorities in the Federal Republic of Germany as to money transactions of non-banking companies is to prevent abuses in the money market and especially to save the depositors from loss. With this end in view, certain transactions are subject to State supervision essentially with regard to the acceptance of deposits and taking of money from third parties as loans and granting of advances. Acceptance of deposits by a non-banking company amounts to conducting banking transactions which, in principle, are generally permissible. If, however, its volume requires a commercially organised business enterprise, the deposit receiving company is considered as credit institution and as such it is subject to bank supervision under the regulations applicable to banking business. Deposits can be accepted in this case only with the permission of the Federal Supervisory Office. Credit institutions are required to observe certain requirements of equity capital and maintenance of liquidity as prescribed by the Authority. They have to invest their funds in such a way so as to safeguard 'adequate solvency' at all times. Credits granted to any one borrower in excess of 15 per cent of the credit institution's 'liable funds' are to be reported to the Central Bank. Further, large credits should not exceed in the aggregate 50 per cent of the total lendings and a single credit should not exceed the total liable funds; hire-purchase companies are, however, exempted from these restrictions. There are also certain restrictions on the grant of loans to directors. Investigation of non-banking companies may be carried out by the concerned authorities.

APPENDIX VI

STATEMENT SHOWING THE SALIENT FEATURES OF THE THREE SETS OF DIRECTIONS ISSUED BY THE RESERVE BANK OF INDIA TO NON-BANKING COMPANIES (POSITION AS ON JANUARY 27, 1975)

Non-Banking Financial Companies (Reserve Bank) Directions, 1966 contained in Notification No. DNBC. 1/ED(S)-66 dated October 29, 1966 as amended upto January 27, 1975	Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 contained in Notification No. DNBC. 2/ED(S)-66 dated October 29, 1966* as amended upto January 27, 1975	Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 contained in Notification No. DNBC. 21/DG(S)-73 dated August 23, 1973 as amended upto January 27, 1975
(1)	(2)	(3)
I. **Date of commencement of the directions** January 1, 1967	January 1, 1967.	September 1, 1973.
II. **Types of non-banking companies covered** (Banking, insurance and stock exchange or stock-broking companies are excluded from the purview of all the three sets of directions)		
(i) **Hire-Purchase Finance Companies**—Companies carrying on as their principal business hire-purchase transactions or the financing of such transactions.	All industrial, trading and other companies which are not financial or miscellaneous non-banking companies.	All non-banking companies which carry on any of the following types of business: (1) collecting whether as a promoter, foreman, agent or in any other capacity, monies in lump sum or in instalments by way of contributions, or subscriptions or by sale of units, certificates or other instruments or in any other manner or as membership fees or admission fees or service charges to or in respect of any savings, mutual benefit, thrift, or any other scheme or arrangement by whatever name called,
(ii) **Housing Finance Companies**—Companies the principal business of which is the financing of the acquisition or construction of houses, including the acquisition or development of plots of land in connection therewith.		

* Withdrawn with effect from June 3, 1975.

(1)	(2)	(3)
		and utilising the monies so collected or any part thereof or the income accruing from investment or other use of such monies for all or any of the following purposes:
(iii) **Investment Companies**—Companies carrying on as their principal business the acquisition of securities, viz., shares, stock, bonds, debentures, debenture stock or securities issued by Government or by a local authority or other marketable securities of a like nature.		(a) giving or awarding periodically or otherwise to a specified number of subscribers as determined by lot, draw or in any other manner, prizes or gifts in cash or in kind, whether or not the recipient of the prize or gift is under a liability to make any further payment in respect of such schemes or arrangement;
(iv) **Loan Companies**—Companies carrying on as their principal business the providing of finance whether by making loans or advances or otherwise but excluding hire-purchase, housing finance, industrial and trading companies.		(b) refunding to the subscribers or such of them as have not won any prize or gift, the whole or part of the subscriptions, contributions or other monies collected, with or without any bonus, premium, interest or other advantage, howsoever called, on the termination of the scheme or arrangement, or on or after the expiry of the period stipulated therein;
(v) **Mutual benefit Financial Companies**—Companies the principal business of which is the acceptance of deposits from their members and which are notified by the Central Government under Section 620A of the Companies Act, 1956.		(2) managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum

(1)	(2)	(3)
(vi) **Miscellaneous Financial Companies**—Companies carrying on as a part of their business but not as their principal business, two or more classes of financial business as referred to at items (i) to (v) above.		in instalments over a definite period and that every one of such subscriber shall in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement be entitled to the prize amount; **Explanation:** For the purposes of this sub-paragraph, the expression 'prize amount' shall mean the amount, by whatever name it be called, arrived at by deduction from out of the total amount subscribed at each instalment by all subscribers, (a) the commission charged by the company or service charges as a promoter or a foreman or an agent and (b) any sum which a subscriber agrees to forego, from out of the total subscriptions of each instalment, in consideration of the balance being paid to him. (3) conducting any other form of chit or kuri which is different from the type of business referred to in sub-paragraph (2) above; (4) undertaking or carrying on or engaging in or executing any other business similar to the business referred to in sub-paragraphs (1) to (3).

(1)	(2)	(3)
III. **Definition of the term 'deposit'** For the purpose of the directions the term 'deposit' means any deposit of money with, and includes any amount borrowed by a non-banking financial company but does not include certain types of borrowings such as, money received from or guaranteed by Central or State Governments, local authorities or from foreign sources, borrowings from commercial banks or specified financial institutions, inter-company borrowings, money received from directors or by private companies from their shareholders under a declaration that money lent to the company has not been acquired by them by borrowing or accepting deposits from another person, security deposits from employees, dealership deposits/advances received against orders for goods, properties or services, subscriptions to any shares, etc., calls in advance (subject to certain conditions) and money received in trust or money in transit (vide paragraph 2(1)(f) of the Notification). Note: (i) Monies received by a mutual benefit financial company vide item II(v) above from its members (shareholders) are not treated as deposits.	Same as in column (1) except that any money received by a non-banking non-financial company from the Unit Trust of India by way of bridging accommodation is also not treated as 'deposit'.	Same as in column 1 except that any money received or collected under a chit transaction or arrangement referred to in sub-paragraph (2) of paragraph 2 of the Notification [vide item II(2) above] is not treated as deposit; dealership deposits etc. or monies received in trust or monies in transit are also not exempt (vide paragraph 3(1)(d) of the Notification).

(1)	(2)	(3)
(ii) By the Reserve Bank of India (Amendment) Act 51 of 1974 which came into force with effect from December 13, 1974, the term 'deposit' has been defined in clause (bb) in section 45-I of the principal Act, as under: "(bb) 'deposit' shall include, and shall be deemed always to have included, any money received by a non-banking institution by way of deposit, or loan or in any other form, but shall not include amounts raised, by way of share capital, or contributed as capital by partners of a firm".		
IV. **Period of deposits** Minimum period prescribed under the directions for the acceptance of deposit is six months. Acceptance of deposit repayable on demand or on notice is prohibited.	Same as in column 1 except that non-banking non-financial companies can accept certain types of deposits (i.e. deposits from members, deposits guaranteed by directors and unsecured debentures) for a period of three months upto 10% of their net owned funds within the overall ceiling limit mentioned at item V(A) below for meeting their seasonal requirements of funds.	Same as in column 1.
Note: Mutual Benefit financial companies are, however, permitted to accept deposits from their members for any periods.		

(1)	(2)	(3)
V. **Ceiling on deposits** Prior to January 27, 1975, non-banking financial companies were permitted to accept deposits upto the ceiling limits of 25 per cent of the paid-up capital and free reserves (as reduced by accumulated balance of loss, if any), hereinafter referred to as net owned funds in respect of **each** of the following **two** categories of deposits, namely—	Same as in the case of non-banking financial companies vide column 1.	Same as in column 1 except that for the purpose of computing category—I, loans guaranteed by the former managing agents or secretaries and treasurers are not to be included.
Category—I (A) (i) deposits including unsecured loans from members (shareholders) (not being deposits received by a private company from its members); (ii) unsecured debentures; (iii) deposits including unsecured loans guaranteed by directors in their individual capacity; and (iv) unsecured loans guaranteed by the former managing agents or secretaries and treasurers.		
Category—II (B) All other deposits: With effect from January 27, 1975, ceiling in respect of deposits in the form		

(1)	(2)	(3)

of unsecured loans guaranteed by directors, deposits from shareholders etc. [vide item (A) above] has been reduced from 25 per cent to 15 per cent of the net owned funds.

Note: The ceiling restrictions do not apply to hire-purchase finance and housing finance companies.

Any loans secured by the creation of a mortgage or pledge of the assets of the company or any part thereof shall not be taken into account for the purpose of the ceilings mentioned above provided:

(a) there is a margin of at least 25 per cent of the market value of the assets charged as security for the loan; and

(b) in case more than twenty persons are given the same assets as security for the loan, mortgage or pledge, as the case may be, is also created in favour of a trustee, which should be either a scheduled commercial bank or an executor and trustee company which is a subsidiary of such scheduled commercial bank and the company has executed a trust deed in favour of such scheduled commercial bank or its subsidiary.

(1)	(2)	(3)
If the Reserve Bank is satisfied that a mortgage or a pledge created by a company is not in the public interest, it may declare that the deposit sought to be secured by such mortgage or pledge shall still be deemed to be deposits and shall not be entitled to the above benefit.		
VI. **Regularisation of deposits held in excess of ceiling limits**		
(i) Excess deposits of the kinds mentioned at item V(A) above, as at the commencement of business on January 1, 1972 were to be reduced in a phased manner before April 1, 1975 — at least one third of the excess, before April 1, 1973, at least another one third before April 1, 1974 and the balance before April 1, 1975.	Same as in column 1, except that item (iv) is not applicable to non-banking non-financial companies.	(i) Deposits held in excess of the two ceiling limits as at the commencement of business on September 1, 1973 have to be adjusted in a phased manner before October 1, 1976, i.e. at least one-third before October 1, 1974, at least another one-third before October 1, 1975 and the balance before October 1, 1976.
(ii) Companies holding deposits of the kinds mentioned at item V(A) above in excess of 15 per cent of their owned funds as on January 27, 1975 are required, to wipe off such excess before December 31, 1975. This is without prejudice to the requirement mentioned in item (i) above.		(ii) Companies holding deposits of the kind mentioned at item V(A) of column 1 in excess of 15 per cent of their owned funds as on January 27, 1975 are required to wipe off such excess before December 31, 1976. This is without prejudice to the requirement mentioned in item (i) above.

(1)	(2)	(3)
(iii) Excess deposits of the type mentioned at item V(B) above solely as a result of deduction of balance of loss from the owned funds were to be regularised before April 1, 1973.		
(iv) Consequent upon the withdrawal of the exemption relating to deposits received by mutual benefit financial companies from their associate members with effect from January 1, 1973, such deposits in excess of 25 per cent of the net owned funds of the company were required to be regularised before January 1, 1974.		
VII. **Regularisation of deposits for periods of less than the minimum period prescribed**		
(i) Every non-banking financial company which as at the commencement of business on January 1, 1972 held any deposits of one or more of the four kinds referred to at item V(A) above and repayable on demand or on notice or after a period of less than six months from the date of receipt of such deposits was required to regularise such deposits	Same as in column 1 except that as stated earlier, non-banking non-financial companies are also permitted to accept deposits for three months, upto a certain limit prescribed in the directions.	Every miscellaneous non-banking company which as at the commencement of business on September 1, 1973 held any deposits of one or more of the kinds referred to at items V(A) & (B) of column 1, and repayable on demand or on notice or after a period of less than six months from the date of receipt of such deposits was required to regularise such irregular deposits

(1)	(2)	(3)
(i) before April 1, 1973 if total amount of irregular deposits was not in excess of 25 per cent of the company's net owned funds; (ii) if the total amount of irregular deposits was in excess of 25 per cent of the company's net owned funds; (a) at least such deposits equal to 25 per cent of the net owned funds before April 1, 1973; (b) at least one-half of the balance before April 1, 1974; and (c) the remaining portion before April 1, 1975.		(i) before October 1, 1974 if the total amount of the deposits was not in excess of 25 per cent of the company's net owned funds; (ii) if the total amount of irregular deposits was in excess of 25 per cent of the company's net owned funds, it should be regularised in the following manner: (a) at least such deposits equal to 25 per cent of the net owned funds before October 1, 1974; (b) at least one half of the balance before October 1, 1975; and (c) the remaining portion before October 1, 1976.
VIII. **Advertisements soliciting deposits**		
(a) Advertisements issued by non-banking financial companies soliciting deposits from the public should contain certain prescribed particulars regarding their management, business, financial position, etc.	(a) and (b) same as in column 1.	(a) Same as in column 1.
(b) Every non-banking financial company is required, with effect from April 1, 1973, to accept, renew or convert any deposit on a written application by the depositor on the form to be supplied by the company, which form should contain all particulars referred to in item (a) above.		(b) Same as in column 1, except that the relevant provision is effective from January 1, 1974.

(1)	(2)	(3)
IX. Furnishing of receipts to depositors		
Every non-banking financial company is required to furnish to every depositor, a receipt containing certain particulars prescribed in the relative direction.	Same as in column 1.	Same as in column 1.
X. Register of deposits		
Every non-banking financial company is required to maintain one or more registers for recording certain specified particulars in the case of each depositor. The registers are required to be kept at the registered office of the company and preserved in good order for eight calendar years following the financial year in which the latest entry is made of the repayment or renewal of any deposit of which particulars are contained in the register. [The relative direction also requires the company to deliver a copy of the notice filed with the Registrar under the proviso to section 209(1) of the Companies Act, 1956 to the Reserve Bank within seven days of such filing, in case the company keeps its books at any place other than its registered office].	Same as in column 1.	Same as in column 1.

(1)	(2)	(3)
XI. **Information to be included in the Board's report** Certain particulars of unclaimed/unpaid deposits are required to be included in every report of the Board of Directors laid before a company in its general meeting under section 217(1) of the Companies Act, 1956 and, in case such deposits exceed Rs 5 lakhs, the company should also indicate the steps taken or proposed to be taken by the Board for payment of the amounts due to the depositors and remaining unclaimed or undisbursed.	Same as in column 1.	Same as in column 1.
XII. **Repayment of deposits before maturity** In respect of any deposit which is repaid before the date on which it is due for repayment but on or after the expiry of six months from the date of receipt of such deposit, no non-banking financial company shall pay interest at the rate exceeding the contracted rate per annum less one per cent and in the case of repayment of deposits before the expiry of six months, at the rates prescribed in the directions. The provision is, however, not applicable where the terms and conditions governing the deposits provide for earlier repayment of the deposit by such company at its option.	Same as in column 1.	No such provision.

(1)	(2)	(3)
XIII. **Maintenance of a minimum percentage of liquid assets** Hire-purchase and housing finance companies are required to maintain liquid assets in the form of cash, bank deposits or unencumbered Government securities which should not be less than 10 per cent of the deposits received by the company and outstanding on the books of the company on any day.	No such provision.	No such provision.
XIV. **Recoveries of hire-purchase debts** Hire-purchase companies and other financial companies carrying on hire-purchase transactions are required to recover during each of the two half-years of the financial year, their hire-purchase debts which should not be less than 25 per cent of such debts outstanding at the close of the previous year.	Non-financial companies engaged in hire-purchase business are also required to adhere to the stipulation mentioned in column 1.	No such provision.
XV. **Submission of balance sheet** Every non-banking financial company whether it holds deposits or not is required to furnish to the Reserve Bank a copy each of its balance sheet and profits and loss account within 15 days of the general meeting in which the annual accounts are passed.	(i) The provision as mentioned in column 1 is applicable to non-financial company only when it retains deposit during any period in any financial year;	Same as in column 1.

(1)	(2)	(3)
	(ii) Before any non-financial company issues any advertisement soliciting deposits from the public, it is required to deliver to the Reserve Bank a copy of the balance sheet dated not more than 15 months before the date on which the advertisement is issued.	
XVI. **Submission of returns**		
(i) Non-banking financial companies irrespective of whether they hold deposits or not are required to submit to the Reserve Bank a return before June 30, with reference to their position as on March 31 of every year in the schedule applicable to them furnishing information specified in such schedule.	(a) Non-banking non-financial companies have to submit the prescribed return before June 30, of any year provided they hold deposits as on March 31, of that year. (b) Non-banking non-financial companies carrying on hire-purchase business are also required to submit return in the Second Schedule to the directions furnishing particulars of hire-purchase transactions in addition to the return at item (a) above.	(i) Miscellaneous non-banking companies irrespective of whether they hold deposits or not are required to submit to the Reserve Bank a return twice a year before June 30, and December 31, with reference to their position as on March 31, and September 30, respectively.
(ii) Particulars of principal officers and directors and specimen signatures of the officers authorised to sign on behalf of	Same as in column 1.	(ii) Same as in column 1 except that the particulars are to be furnished to the Reserve Bank within one month of the coming into

(1)	(2)	(3)
the company, returns specified in item (i) above are required to be furnished to the Bank within one month of the coming into operation of the relative direction, viz., January 1, 1973 or within one month of the occurrence of the change.		operation of the directions viz. September 1, 1973 or within one month of the occurrence of the change.
XVII. **Exemptions** The Reserve Bank of India, may, if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, grant extensions of time to comply with, or exempt any non-banking financial company or class of such companies from, all or any of the provisions of the directions either generally or for any specified period subject to such conditions as the Bank may impose.	Same as in column 1.	Same as in column 1.
XVIII. **Non-applicability of certain other directions** No such provision.	No such provision.	The provisions of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 or the Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 are not applicable to miscellaneous non-banking companies covered by the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973.

APPENDIX VII

MAIN POINTS OF DIFFERENCE BETWEEN THE DIRECTIONS CONTAINED IN THE NON-BANKING NON-FINANCIAL COMPANIES (RESERVE BANK) DIRECTIONS, 1966 AND THE COMPANIES (ACCEPTANCE OF DEPOSITS) RULES, 1975

The Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966*	The Companies (Acceptance of Deposits) Rules, 1975
(1)	(2)
(a) **Applicability to foreign companies** [vide paragraph 2(1)(e)]	
Foreign companies within the meaning of section 591 of the Companies Act, 1956 are also covered by the directions.	The Rules do not cover foreign companies.
(b) **Declaration to be furnished by depositors** [vide paragraph 2(1)(f)(vii)]	
A declaration by a depositor to the effect that the money has not been given by him out of funds acquired by him by borrowing or accepting deposits from another person is necessary only in the case of money received from a person, who at the time of the receipt of the money was or is a director of the company or any money received before April 3, 1970* from persons, who at the time of receipt of the money were managing agents or secretaries and treasurers of the company or in respect of any money received by a private company from its shareholders.	A declaration to the effect that the amount is not being deposited out of the funds acquired by the depositor by borrowing or accepting deposits from any other person has to be made by every person making the deposit (vide Rule 5).
(c) **Deposits received from the directors** [vide paragraph 2(1)(f)(vii)]	
Deposits received from the directors are exempted from the provisions of the directions subject to the making of a declaration referred to in item (b) above.	No such provision has been made in the Rules.

* Withdrawn with effect from June 3, 1975.

(1)	(2)
(d) **Acceptance of deposits by private companies from their shareholders** [vide paragraph 2(1)(f)(vii)]	
Deposits received by private companies from their shareholders are exempt from the purview of the directions, provided a declaration of the type referred to in item (b) above is made by the shareholders concerned.	Though clause (i) of Rule 3(2) seeks to exclude deposits accepted by private companies from their shareholders, a doubt has been raised whether such deposits would fall within the ceiling of 25 per cent prescribed in clause (ii) of the same Rule.
(e) **Loan secured by the creation of a mortgage or pledge of assets of the company (which is exempt from the ceiling restrictions)** [vide first proviso to paragraph 3(2)(ii)]	
(i) A margin of at least 25 per cent of the market value of the assets charged as security for the loan is required to be maintained;	(i) In the case of a loan secured by the creation of a mortgage, charge or pledge of any of the assets of the company, the amount of such loan should not exceed 25 per cent of the market value of the security [vide Explanation 1 to Rule 3].
(ii) In case more than 20 persons are given the same assets as security for the loan, the mortgage or pledge as the case may be has to be created in favour of a trustee which should be either a scheduled commercial bank or its subsidiary and a trust deed has to be executed in favour of such scheduled bank or its subsidiary as the case may be.	(ii) No such provision has been made in the Rules.
(f) **Aggregate of the paid-up capital and free reserves for the purpose of ceilings etc.** (vide Explanation to paragraph 4)	
In arriving at the net owned funds for the purpose of working out ceilings, etc., only the accumulated balance of loss, if any, as appearing in the balance sheet of the company, is required to be deducted from the aggregate of its paid-up capital and free reserves.	Apart from the balance of accumulated loss, the balance of deferred revenue expenditure and other intangible assets, if any, as disclosed in the balance sheet of a company, are required to be deducted from the aggregate of its paid-up capital and free reserves (vide Explanation 2 to Rule 3).

(1)	(2)
(g) **Particulars to be specified in advertisement soliciting deposits** (vide paragraph 5)	
Certain requirements, as prescribed in the Rules, have not been provided for in the directions. The directions provide for the information to be published in the advertisement soliciting deposits but the issue of advertisement is not compulsory. Paragraph 11 of the directions also provides that before making any such advertisement, a non-banking non-financial company shall deliver to the Reserve Bank an audited balance sheet dated not more than fifteen months before the date on which the advertisement is issued.	It is compulsory on the part of the companies intending to invite or accept deposits to advertise in a leading English newspaper and in one vernacular newspaper circulating in the State in which the registered office of the company is situate except in the case of acceptance of deposits from directors. Certain particulars (in addition to those prescribed in the directions) such as an account of the proposed utilisation of the deposits have to be given in the advertisement and a copy thereof to be filed with the Registrar of Companies concerned on or before the date of its issue; furthermore, the validity period of the advertisement is restricted to the financial year in which it is issued (vide Rule 4).
(h) **Submission of returns** (vide paragraph 12)	
The return to be submitted to the Reserve Bank should relate to the period ending March 31 of each year irrespective of the financial year of the company concerned.	A return is to be filed with the Registrar of Companies in each year, within thirty days from the last day of its financial year containing certain particulars specified in Rule 10.
(i) **Penalties**	
The penalties for contravention of the provisions of the directions have been provided for in sections 58B and 58C of the Reserve Bank of India Act, 1934 itself.	The penalties for contravention of the Rules for which no provision has been made in the Companies Act, 1956 have been specified in Rule 11.
(j) **Special provisions relating to non-financial companies accepting deposits and financing hire-purchase transactions in addition to any other business** (vide paragraph 10)	
Non-financial companies which accept deposits and which are also engaged in hire-purchase business are required to recover, during each of	No such provision in the Rules.

(1)	(2)
the two half-years of the financial year their hire-purchase debts which should not be less than 25 per cent of such debts outstanding at the close of business of the previous year.	
(k) **Granting exemption from or extension of time for complying with all or any of the provisions** (vide Rule 14)	
For avoiding hardship or for any other just and sufficient reason, the Reserve Bank is empowered to grant exemption or extension of time in deserving cases.	Similar provision has not been made in the Rules. However, nothing contained in section 58A of the Companies Act, 1956 shall apply to any company as may be specified by the Central Government after consultation with the Reserve Bank.

APPENDIX VIII

COPY OF LETTER DATED JUNE 30, 1975 FROM SHRI J. S. RAJ, CHAIRMAN OF THE STUDY GROUP TO SHRI S. S. SHIRALKAR, DEPUTY GOVERNOR, RESERVE BANK OF INDIA

Study Group on Non-Banking Companies—Model Legislation for regulating chit funds

As you are aware, the draft Bill on Chit Funds prepared by the Reserve Bank in its Department of Non-Banking Companies had been referred to the Study Group for its comments, more particularly in regard to the policy aspects of certain new provisions incorporated in the Bill. The Group has had discussions in this regard at two of its meetings. Before finalising its views, the Group took into account the opinions expressed by the representatives of some of the State Governments which have enacted legislation regulating chit funds in their respective States as also certain individuals having an intimate knowledge of the running of chits. The Group's views on the various aspects have been given in the Annexure. The more important aspects are dealt with in the following paragraphs.

2. Before considering the provisions of the Bill, the main question which arose for the Group's consideration was whether the Bill should be enacted as a Central Act by Parliament or whether it should be forwarded by the Central Government to all State Governments which have no such legislation, to be adopted by them; further, if it is to be enacted as Central legislation, who should be the administering authority. In this connection, the Group was unanimously of the view that the Bill should be enacted as Central legislation as such a step, besides ensuring uniformity in the provisions applicable to chit fund institutions throughout the country, would also prevent such institutions from taking undue advantage either of the absence of any law governing chit funds in any State or exploit benefits of any lacuna or relaxation in any State law by extending their activities to such States. The Group was given to understand that Parliament is competent to enact the necessary law in view of the provisions contained in Entry 7 of List III (Concurrent List) of Schedule VII to the Constitution of India. As regards the appropriate authority for administering the proposed legislation, the consensus was that, while logically, policy formulation as also control of chit funds should vest in the Reserve Bank as in the case of other financial companies, since chit fund institutions are quite numerous and spread all over the country, it would not be administratively feasible for the Reserve Bank to exercise effective control over the functioning of these companies by means of regular inspections or otherwise. Furthermore, under the enactments in force in States such as Tamil Nadu and Kerala, provision has already been made for inspection of such institutions by their own officers and it may not be necessary or desirable for the Reserve Bank to duplicate these functions. The Group was, therefore, of the view that the administration of the proposed legislation should be left to the State Governments concerned which, in turn, could seek the advice and assistance of the Reserve Bank on policy matters.

3. Another aspect which engaged the attention of the Group relates to the question whether it should be made a requirement of law that only public limited companies should be allowed to conduct chit funds. Since the subscriptions accepted by conventional chit funds stand on a different footing and chit schemes are of a self-liquidating nature which partake the character of mutual benefit schemes, the Group felt that there should be no objection, in principle, to chits being conducted by private limited companies and on a limited scale, even by unincorporated bodies such as individuals/

sole proprietorships/partnership firms. It is observed that private limited companies and unincorporated bodies which have played a traditional role in mopping up savings of the community, are doing a sizeable amount of chit business and serving as a source of livelihood/employment to a good number of rural population. The information collected from some of the State Governments does not also indicate that malpractices indulged in/offences committed by these institutions are on a larger scale than those by public limited companies. The Group was, therefore, of the view that private limited companies and unincorporated bodies may also be allowed to run chits, the latter on a restricted scale as indicated against items 3 and 9 of the Annexure. The Group felt that the question, in the ultimate analysis, was one of making adequate provisions in the legislation to safeguard the interests of the subscribers and thus reducing, to the extent possible, the scope for the commission of malpractices.

4. Having regard to the nature of business transacted by chit fund institutions, the Group was of the view that there was no necessity for these institutions to borrow funds from the public by way of deposits and as such they may be prohibited from accepting deposits except as advance payment of subscriptions or deposits from prized subscribers by way of security towards payment of future instalments.

5. In the light of the foregoing observations, the Reserve Bank may like to give its further consideration to the matter and recast the relative provisions of the Bill, if deemed necessary.

With kind regards,

ANNEXURE

Issues for consideration	Views of the Study Group
1. Whether institutions conducting chit funds should be prohibited from doing any other type of business? If so, the period that may be allowed to such companies to divest themselves of non-chit business.	Companies as also unincorporated bodies such as individuals/sole proprietorships/ partnership firms conducting chits may be prohibited from doing any other type of business except chit business or granting of loans to subscribers against their paid-up subscriptions. If they are currently conducting non-chit business, they may be allowed time not exceeding three years or such extended period not exceeding three years as may be allowed by the State Government for divesting themselves of non-chit business. During such period, they may be allowed to carry on non-chit business for the beneficial winding up of such business as proposed in clause 5 of the Bill. Further, if the institution conducting chits is an incorporated body, it shall use as part of its name any of the words 'chit', 'chit fund' or 'kuri' and no company shall carry on the business of chit funds unless it uses as part of its name at least one of such words.
2. Utilisation of funds.	Institutions conducting chits may be permitted to utilise their funds only in the manner contemplated in clause 6 of the Bill. Those holding investments of the type other than those mentioned in the said clause may be required to regularise them within a period of three years from the date of coming into operation of the Act or such extended period not exceeding three years as the State Government may allow.
3. Opening of offices/branches.	The Group is in agreement with the proposal that chit fund companies may be prohibited from opening new places of business without obtaining the prior approval of the Director of Chits within whose jurisdiction the registered offices of the companies are situated. Before granting such approval, the Director of Chits may take into account the criteria laid down in clause 7(2) of the Bill. Unincorporated bodies should not be allowed to conduct business at more than one place.

Issues for consideration	Views of the Study Group
4. Particulars to be given by chit fund companies in the advertisement to be issued by them inviting/soliciting subscriptions from the public to their schemes.	It does not appear necessary that the particulars specified in clause 9, should be given in the advertisements issued on each occasion when new schemes are started since it would prove to be very expensive to the companies. Instead, such particulars may be given in the application forms for enlisting members for each chit.
5. Maximum duration of chits.	The duration of chits should not ordinarily exceed five years, but chits of longer duration up to ten years may be started in very special cases only by chit fund companies/ banks with the prior approval of the State Government concerned which should take into account factors such as the financial position of the company in question and its methods of operation, interests of the prospective subscribers, requirements as to security etc. (The security deposit to be kept by foreman in the case of chits of longer duration should be proportionately higher).
6. Period of preservation of chit records.	This may be six years from the date of the termination of chits, as proposed in clause 40 of the Bill.
7. Mode of settlement of disputes.	The machinery for settlement of disputes arising between the foreman and the subscribers relating to adequacy of security offered by prized subscribers to the foreman for payment of future instalments, substitution of subscribers in case of default, etc. should be self-contained, cheap and expeditious on the lines of the machinery prescribed under the State co-operative laws for settlement of disputes by arbitration. For this purpose, the provisions in Chapters IX and XIII of the Maharashtra State Co-operative Societies Act, 1960 may be considered.
8. Uniformity in the presentation of annual accounts by chit fund institutions.	The Bill may prescribe a proforma of the balance sheet and profit and loss account in which chit fund institutions may be required to present their annual accounts.
9. Ceiling in respect of the aggregate amount of chits that may be conducted at any point of time.	The aggregate amount of chits conducted by a chit fund company at any point of time may not exceed 50 per cent of the net worth of the company i.e. the paid-up

Issues for consideration	Views of the Study Group
	capital plus free reserves less balance of accumulated loss, and other intangible assets such as deferred revenue expenditure, goodwill, etc., if any [vide clause 8(6)]. In the case of commercial banks conducting chit funds, no ceiling on the aggregate amount of chits that may be conducted at any point of time need be prescribed, since chits conducted by commercial banks are subject to the close scrutiny of the Reserve Bank. As regards the chit funds conducted by unincorporated bodies such as individuals, sole proprietorships and partnerships, the aggregate amount of chits should not at any point of time exceed Rs 10,000. They are prohibited from opening branches (vide item 3 above).
). Minimum capital requirements and creation of a reserve fund.	The minimum paid-up capital of chit fund companies incorporated under the Companies Act—whether private or public—should be Rs 1 lakh. Companies having paid-up capital of less than Rs 1 lakh may be allowed time up to three years to increase their paid-up capital to the minimum referred to above. The State Government concerned may be authorised to grant extension of time for a period not exceeding two years in appropriate cases. Such companies may also be required to credit 20 per cent of their annual net profits to a reserve fund.
. Cognizability of offences.	Certain offences of a serious nature under the proposed legislation may be made cognizable.

APPENDIX IX

STATEMENT SHOWING STAFF POSITION OF DNBC AS ON 31ST MAY 1975

Central Office, Calcutta

	Staff strength			
	Sanctioned			Actual
	Permanent	Temporary	Total	
Chief Officer	1	—	1	1
Assistant Chief Officer	1	1	2	2
Staff Officers Gr. I	7	2	9	9
Staff Officers Gr. II	7	2	9	9
Clerks Gr. I	9	3	12	14
Clerks Gr. II	29	8	37	35
Stenographer Gr. I	1	—	1	1
Stenographer Gr. II	1	—	1	1
Typists	5	—	5	5
Subedar Gr. II	1	—	1	1
Duftary	2	—	2	2
Peons	5	2	7	7
Total	69	18	87	87

II. **Regional Cell, Bombay**

	Staff strength	
	Sanctioned	Actual
Assistant Chief Officer	1	1
Staff Officers Gr. I	2	2
Staff Officers Gr. II	2	2
Clerks Gr. I	2	—
Clerk Gr. II	1	1
Stenographer Gr. II	1	1
Typist	1	1
Duftary	1	—
Peons	2	1
Total	13	9